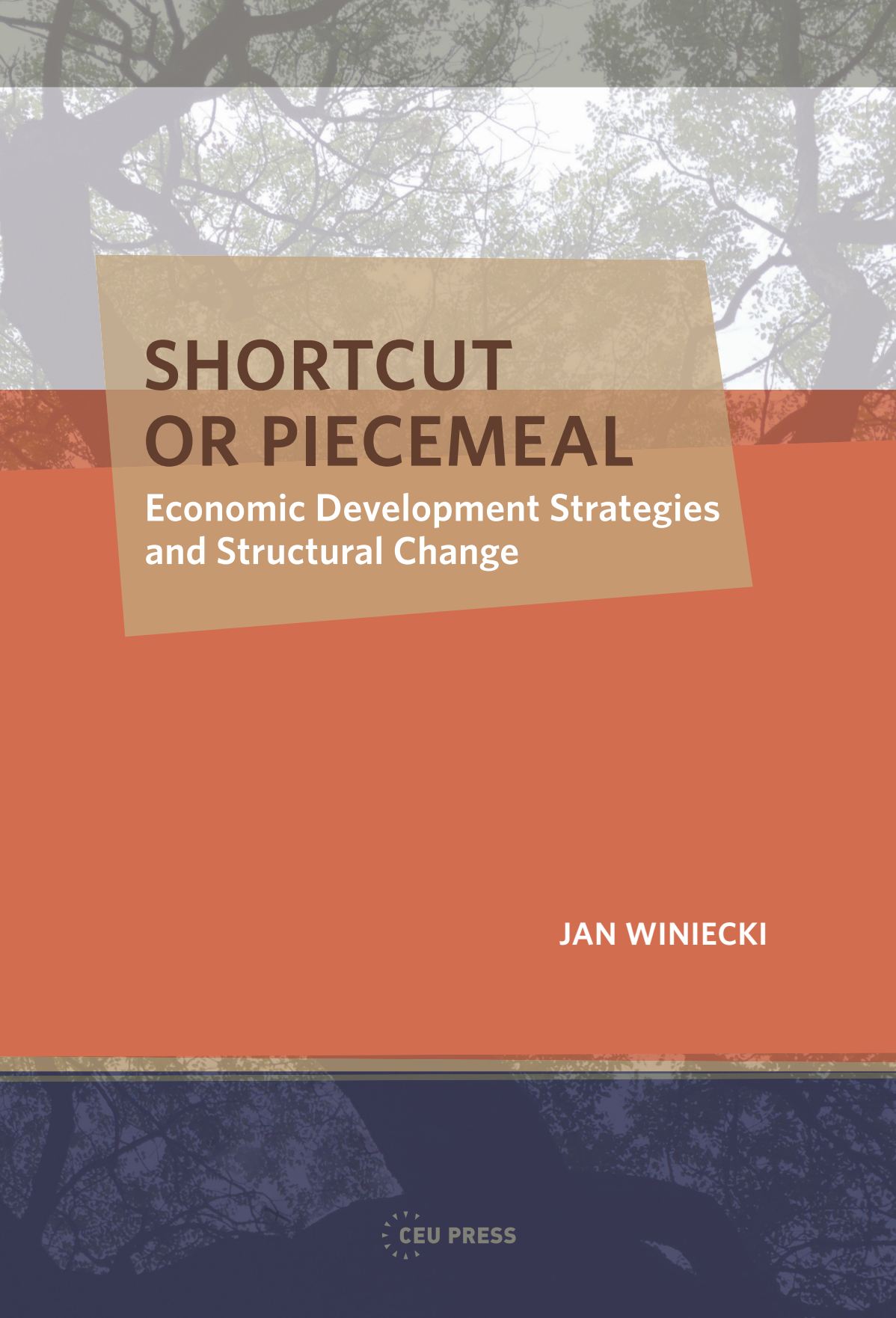




SHORTCUT OR PIECEMEAL

Economic Development Strategies
and Structural Change

JAN WINIECKI

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*Economic Development Strategies
and Structural Change*

JAN WINIECKI



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To my erudite friend, Jacek Szymanderski,
in the appreciation of almost half a century
of intellectually stimulating discussions.

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Introduction

My prime interest is in economic change taking place in the process of development and, additionally, in its policy determinants—past, present, and future. Therefore, Part I of the book looks at the developmental strategies most often applied over the period of the last hundred years. More precisely, since 1917, when the first Marxian-based economic system and associated state strategy were briefly (but devastatingly!) applied. Next came the centrally planned and administered economy (command economy) that also turned out to be a failure, although it collapsed after more than six decades.

Altogether, Part I consists of three chapters. Chapters 1 and 2 look at two popular types of strategies, similar in their philosophy and intent, that is, a communist command economy and a highly interventionist strategy based on the economic thinking known as *development economics* (see Chapter 2 for details). Both were state-driven and undertaken in the hope for a “shortcut,” which would see industrialization accomplished over a much shorter time-span than it took the West.

The third and last chapter in Part I relates these two “shortcut” strategies to the ideas of classical economics. It looks at these ideas within the framework of departures from and returns to the classical ideas of economic development. By “classical” I mean the framework of a capitalist market internally and economic openness externally. The chapter follows twists and turns in the policies of poor countries of the South (Asia, Middle East, Africa, and Latin America) as they coped with distortions generated by “shortcut” strategies. Over time, as problems of economic growth were pushed aside by growth of economic problems, the search for other than “shortcut”-type solutions—however hesitant and halting—began. And, more often than not, the solutions found were precisely those which strengthened the role of markets domestically and opened them up to the stimuli of the world economy.

In contrast to the developments in the South, the shift toward the classical economic prescriptions in communist countries, considered in Chapter 1,

was abrupt. It took place very late, in the 1989–91 period, during the time when the system and strategy were already crumbling under the weight of systemic internal inconsistencies and incompetence in governance. To balance the picture, however, it is worth stressing that what often took some countries of the South decades (and often has not been completed even now), that is the shift to a competitive market economy model, took a decade or even less in countries departing in earnest from communism and central planning (clearly, only some did).

But whether leaving the “shortcut” strategies abruptly or on a piecemeal basis, the judgment on the strategies analyzed in Chapters 1 and 2 is roughly the same: the abandoned strategies were not worth the bother. Costs were higher than (often non-existent) benefits. This judgment is not of historical importance only. After all, many Southern, less developed countries still face the task of starting in earnest or continuing the industrialization phase of the economic development process. They should be able to learn from history.

Another interest of mine, displayed in this book, is aligned with the fact that economies not only grow, but also change. As growth, measured conventionally by GDP per capita, accumulates, changes occur on the supply side of the economy, which make further growth faster, less costly, or at all possible. In Part II, I start with the obvious conclusion that growth and change take place all the time throughout the process of economic development. However, two phases within that process deserve particular attention. I deal with them in turn in Chapters 4 and 5.

The first such phase is that of industrialization, when the economy changes from the one driven (slowly!) by agriculture to that driven (faster) by industry, particularly manufacturing. It is a well-researched phase of economic development, with an extensive literature about recognizable patterns of structural change. What I add to these descriptions and explanations are certainly less often discussed, but important characteristics, both specific and general. The specific applies to centrally planned and administered (command) economies, whose structure of production and employment were even more distorted than those of less developed countries of the South, due to the combined influence of both economic system and developmental strategy. The general characteristic applies to the qualitative difference between structural change achieved or attempted via “shortcut” strategies aimed at industrialization and the much less state-driven strategies based largely on spontaneous process of economic development. Although both resulted in the (desired) increase in the share of manufacturing in GDP, the former strategies created industries whose firms were largely incapable of competing against Western firms not only in world markets but also in their domestic markets. “Shortcuts” turned out to be a recipe for inferior quality of output from manufacturing firms in those industries in which these economies did not possess comparative advantages. These and other general issues are dealt with in Chapter 4.

From my perspective, the second specific phase in the process of economic development is even more interesting. Chapter 5 analyzes the next—and

ongoing—phase of structural change, namely the shift from a manufacturing industry-driven to services-driven economy. Given its ongoing nature, we know relatively less about the determinants, manifestations, and outcomes of that phase of economic development. Some theorizing in this area of economics is decades old, predicting the forthcoming shift in the structure of the economy of already industrialized countries. However, the latest theorizing narrows the driver's role mostly to human capital-intensive services.

Moreover, a highly innovative empirical literature has been trying recently to answer the questions associated with economic growth in modern developed, high-income, as well as middle-developed, middle-income, industrializing, or already industrialized economies. That literature differentiates between the traditional, fixed, or tangible, capital investment and the often intellectual property-based intangible investment. The latter goes far beyond research and development, usually associated with intellectual property. Significantly, intangible investment, measured in terms of its share of GDP, tends to increase with the level of economic development.

The foregoing patterns suggest to those interested in economic development to consider not only the drivers of growth and change, but also their enabling factors. A look at developed, mostly Western countries, whose economies are increasingly relying on intangible investment for economic growth, points at an answer. The enormous variety of intangible investments, revealed and estimated in the empirical literature, could not materialize without the enabling conditions not only of economic freedom, but also civic as well as political freedom.

I try to explain in Chapter 5 why, without these extended freedoms, the flourishing of intangible investment could not have happened in all its wide variety, quality, and quantity. As a consequence, its absence could prevent certain countries from crossing the “Great Wall,” that is, the barrier separating middle-developed, middle-income economies from highly-developed, high-income ones. The crossing, as stressed by the authors of the term, Antonio Fatás and Ilian Mihov, requires high-quality institutions.

Establishing the determinants of structural change and outlining earlier developmental strategies, and their impact on growth and change, creates an opportunity to look at some middle-developed economies in terms of their ability to improve the quality of their institutions. For it seems almost certain that without such improvements they would not be able to join the category of developed, high-income economies. This crossing of the “Great Wall,” the term used in an obvious reference to China, requires higher quality institutions, not only economic ones, than those presently enjoyed by the most obvious candidates from among the middle-developed economies.

Therefore, in Part III, I decided to evaluate the prospects of countries known as the BRIC group. In Chapters 6 and 7, I consider, in turn, first Russia and China, and next, India and Brazil. This pairwise analysis is justified by the

partly different determinants of institutional changes in the past and their prospects in the future for each pair of countries. Neither, however, puts one pair of countries or another in a category of safe bets as far as the shift to the developed, high-income economy category. Moreover, each country additionally reveals its own specific problems affecting—often adversely—the prospects of crossing the “Great Wall” considered in the book.

Finally, I decided to add a Postscript where certain intellectual controversies and loose ends would be signaled. The main theme there has been my considerations on people’s choice of inefficient institutions.

At the end acknowledgements are in order. I would like to thank the Earhart Foundation for their help in making this book a reality. As in earlier projects, I found support and encouragement at the early stages of the project and their financial help afterwards in the research and writing the book. The thanks extend to the Polish Heritage Foundation for the efficient administration of the grant.

Another acknowledgement shows my appreciation for the Central European University, where I taught courses on the “Economics of Development” for two consecutive academic years. Undoubtedly, my ideas on economic development have also been influenced by what I taught and by the reactions of students to my ideas presented at CEU and elsewhere.

Part I

DEVELOPMENTAL STRATEGIES
PURSUED OVER THE PAST CENTURY

Roughly from the late 18th century until World War I, economic development had been generally seen as an outcome of spontaneous economic forces, and the role of governments was perceived in Adam Smith's terms of maintaining the "natural system of liberty," conducive for development. Here and there rulers and parliaments intervened—usually with defense needs in mind in periods of rapidly changing military technologies—, but the economies were by and large left to the forces of the market. The role of governments was to maintain the institutional framework supporting a Smithian system. The idea that economic development should become an object of systematic considerations, leading to long-term governmental involvement, was undoubtedly foreign throughout the Western world (the case of Japan belonged to the periphery, not to the mainstream).

Interestingly, the first serious challenge to the intellectual and, by and large, political *status quo* with respect to economic development was also born at the periphery. Tsarist Russia never really became a part of the Western world, although throughout the nineteenth century it was a major power in the so-called Concert of Europe. This Russia collapsed during World War I, and its new (even more despotic) rulers decided to impose their utopian economic views upon the Russian society and economy. They challenged the concept of the liberal (meaning: free market-based) economic system with their own alternative. It was a major change, for the Japanese tried only to copy the dominant capitalist economic system.

Having burned their fingers during the first years of their rule (1917–21), communist leadership introduced—with a lag—another invention, a modified antithesis of the market system, namely the centrally planned and administered economy (in the English language it is more often called a command economy). It was a collectivist system of economic mobilization, intended to reduce the time needed to catch up with the world's advanced economies. In other words, it was the system subordinated to a "shortcut" strategy of catching up by an economic laggard. In 1931 Joseph Stalin, during his first five-year plan, stated that "we are

fifty or a hundred years behind the advanced countries. We must make good this distance in ten years.”¹

Chapter 1 presents and evaluates both the system (institutions) and the strategy of catching up with the advanced West. Some theorists called the latter a “steep ascent” strategy to stress its “shortcut” nature. But it is also worth pointing out that the high level of economic development, desired by the Soviet rulers from Lenin onward, was not meant primarily to raise the living standards of the Russian population. It was to satisfy in the first place the communist leadership’s thirst for a mighty Soviet state as a vanguard of revolution.

Whatever the aims, a high level of economic development had to be achieved to fulfill them. The system and strategy were a complete failure. The “shortcut” did not fulfill its promises. It did not enable the Soviet Union and its later communist dependencies to catch up with the advanced economies of the West. On the contrary, the developmental distance to the West (both in terms of GDP per capita and technological level) was larger at the time of communist collapse than in the earlier periods.

The next, geographically more widespread challenge from a large number of less developed countries, came also from the peripheries—this time from Asia, Africa, Middle East, and Latin America. In tune with the fashion of the period, it was also collectivist in its institutional and policy characteristics. And the chosen strategy was also based on the “shortcut” idea. To give an example, the first president of independent Ghana, Kwame Nkrumah, a great believer in collectivist solutions, was also in a hurry. And, in spite of the much greater developmental distance to the West than in the case of communist Russia, he also declared in late 1950s, like Stalin a quarter of a century earlier, that Ghanaians must achieve over the period of a decade what it took others a century.

The intellectual challenge to the Western classical economic ideas underpinning the policy decisions in many Less Developed Countries (LDCs or “third world” countries, as they were often called at the time) was coming from development economics, a body of thinking distancing itself from classical economics and openly declaring the need to run developmental strategy from the political center.

However, the foregoing challenge was a partial one. A strategy based on development economics’ ideas assumed the guiding role of the state and its respective bureaucratic organizations and policies, but the actual strategy was to be grafted onto the (underdeveloped) market economy. And not only was it underdeveloped, but also—this time by design—it was to be a highly constrained market economy, with sharply limited economic freedoms. So, the development economics-based strategy might be regarded as a lighter version of the steep ascent strategy pursued within the planned economy with the exclusive or overwhelming state ownership. Otherwise the strategies were quite similar in their priorities and arrangements.

¹ J. V. Stalin, *Works* (Moscow: Foreign Languages Publishing House, 1949), vol. 13, 41.

Started independently in many places, with the then highly popular intellectual underpinnings and no less importantly with the support of emerging and expanding development community of international institutions, financially supporting economic development strategies of LDCs, the strategies evoked great enthusiasm. However, also in the case of development economics-based strategy, the reality turned out to be much different from (often enthusiastic) expectations. This story is presented in Chapter 2.

There, I stress that the pattern was to move from the stage of coping with problems of economic growth to the stage of growing economic problems (largely stemming from the strategy itself). Chronologically, hopes and disappointments came in a similar pattern to that of communist countries.

Not only the post-World War II chronology was similar, but also the range of problems affecting both communist and less developed countries was similar as well. This similarity should not be surprising. Both strategies were, as stressed already, “shortcut” strategies intended to implement the industrialization process in a short time span. Accordingly, both pursued the expansion of various industries at the stage, when the supply side of these economies did not yet have enough competence to cope efficiently with complex technological/organizational/financial issues of given industries. The results were high cost and low quality of products, and the more sophisticated the industries, the greater were the distortions they generated. They were chronically uncompetitive on international markets and could survive on their domestic markets only behind high protective walls. A more detailed evaluation in this respect is presented in Chapters 1 and 2.

The developmental strategy based on the highly interventionist thinking of development economics came into practice in many varieties. There were some, limited, successes and many more failures. But, significantly, the only success stories of accomplished industrialization came from a small number of less developed countries that dropped most of development economics’ prescriptions very early in their pursuit of economic development and moved in the direction of more market internally and greater economic openness externally. Their story is briefly presented in a heterodox Chapter 3.

I call it “heterodox” because the story of the so-called four Asian little dragons (Hong Kong, Taiwan, South Korea, Singapore) makes only a small part of Chapter 3, which is a chapter dealing with a global shift toward strategies based on—increasingly well understood and better appreciated—prescriptions of classical economics. I try to stress there that ideas have consequences, and if consequences tend to be disappointing (as in the case of communist strategy and development economics-based one); they generate a search for new ideas and/or a revaluation of the old ones. And such revaluations on the intellectual as well as political plane is the main story of Chapter 3.

John Stuart Mill wrote that ideas need “conspiring circumstances” to triumph. With communist economies entering the period of efficiency problems

and attempts at economic reforms at the turn of 1950s and 1960s, and with LDCs facing the growth of economic problems at roughly the same time, an intellectual reappraisal began in the West with respect to economic development strategies. It began in the West because it was the only democratic part of the world, where such reappraisal could be pursued without serious threats to the critics of the then dominant orthodoxies. Besides, Western economies also faced problems of their own.

Thus, all three areas of the world—capitalist West, communist East, and the much more varied, but overwhelmingly interventionist LDCs—faced mounting economic problems. These problems culminated in the turbulent decade of 1970s at the end of which a political shift began accompanying intellectual shift toward the greater role of markets and greater economic openness. The way it evolved is told in Chapter 3, but it is worth stressing that its corollary was a spectacular collapse of communist economies in 1989–91.

With respect to that last group of countries, one characteristic feature is worth stressing. While LDCs were moving slowly, often reluctantly, in the direction of more capitalist market and greater external openness, the post-communist countries, at least those which were historically a part of the Western world, did it with enthusiasm and as much speed as was possible in the highly difficult circumstances of building capitalist market institutions from the scratch. And they succeeded much above the—then rather skeptical—expectations of the pundits.

Summing up, in contrast with the two earlier considered developmental strategies, the strategy based on capitalist market and external openness turned out to be in most cases a success throughout the world. And it succeeded also in post-communist countries, which faced much greater obstacles than others.

I call the foregoing success an incomplete one. The reasons for the incompleteness of success are presented at some length in the closing section of Chapter 3. There are a number of factors that caution excessive optimism. On the one hand the future is burdened with the radical, irremovable uncertainty, on the other, human ability to mess things up is infinite (incidentally, I dealt with these human abilities in my recent book).²

Finally, one observation is also worth formulating in the closing sentences of this introduction. All three strategies considered in Part I pertain to the main task of economic development over the past century, namely to industrialization. I did not consider there the next challenge, that is, the shift of the driving engine of economic growth from manufacturing to services. Nor do I devote any space to structural changes within the manufacturing sector at the high end of technological sophistication that usually occurs at the time, when manufacturing began to decrease its share in GDP and employment. These and other challenges are dealt with in Part II.

² Jan Winiecki, *Economic Futures of the West* (Cheltenham and Northampton, MA: Edward Elgar, 2013).

CHAPTER 1

Centrally Planned and Administered Economy and Steep Ascent Strategy: A Complete Failure

Whence Came the Economic System Considered Here?

It would be much simpler to call the system—considered here in the context of its impact upon economic development—a Marxist system or a communist system. After all, it had been introduced in the Soviet Union by the communist party. And communists in Soviet Russia (and elsewhere) stressed always that they follow Marx’s teachings in constructing their economic system. But that would be misleading. The system I prefer to call *centrally planned and administered economy* (CPAE for short), which is more often called in English language literature as *command economy* (CE for short), has been introduced by Stalin only in 1928, eleven years after the communist revolution.

The first Marxist, or even Marxian, economic system was introduced right after the revolution by Lenin, and it lasted till 1921. And it was a true Marxian system, complete with the “production for needs, not for profit” and the abolition of money, for this is how Karl Marx envisaged (however vaguely) the system emerging after the much dreamed revolution. In modern political and economic history this system is known as “war communism.”

The system envisaged no economic incentives, only revolutionary consciousness of the masses. Thus, industrial workers were supposed to produce what they were told to produce on the basis of a promise that their need for food would be satisfied by peasants and other needs by fellow workers. Peasants, in turn, were supposed to produce and deliver to the cities agricultural products to satisfy the needs of the industrial and other workers and expect the supply of industrial goods and services from the latter in return.

The system did not work. Peasants, noting that no industrial goods they needed reached the villages, refused to deliver food on say-so and hid it from the ruling communist administrators, who made confiscatory raids on the countryside. Workers in factories and service establishments behaved in a similar manner. Half-starved, they reduced their efforts to a fraction of what it used to be before.

The outcome of what Marxists called poetically in their writings “a jump from the kingdom of [deterministic] necessity to the kingdom of [presumably unconstrained] opportunity” ended in disaster. When the Lenin-led politbureau, the top political body in the communist dictatorship, called off the original Marxian utopia, the economy was fast moving backwards. Industrial output in 1921 amounted to about 10% of what it was in 1914, at the start of World War I. Additionally, agricultural output fell so much that 2-3 million people died of starvation.

The first experiment on the living body of Russian society made ruling communists more cautious. Marxian utopia clearly required a long intermediate period. After a few years of attempts (called “new economic policy”) to restore a minimal level of output and improve economic performance through the reintroduction of money, prices, wages, and even some smaller scale private ownership, the ruling communists under the new leadership of Stalin decided to make yet another attempt to create a communist economic system. Clearly, they learned something and in 1928, when they introduced the centrally planned and administered economy (command economy) and renationalized whatever was in private hands outside agriculture, at least some features of the market economy became a part of the CPAE. Thus, they understood that both managers and workers in state firms needed economic incentives. Accordingly wages, premiums, and bonuses became a part of the system. For these economic incentives to have the desired effect, they had to accept the existence of money.

The role of money in the state enterprise system was largely limited to that of a unit of account, but in some areas of the economy, like consumer goods, they gave the Soviet subjects a measure of choice. It was a far cry from consumer sovereignty in a capitalist market. Consumers could choose only from among the goods and services that the ruling communists commanded to be produced, or—more precisely—from that part of commanded goods that was actually produced (for explanation of the difference, see the following section). But it was a choice nonetheless, something communists never liked.

Communists almost always had a problem of feeding the population; most of the famines in the twentieth century happened in communist countries or those trying to follow their path. The introduction of central planning and collectivized ownership in the agriculture cost millions of lives (note the horror of great hunger in the Ukraine in 1930s). The level of agricultural production from pre-World War I Russia was achieved in the Soviet Union only in 1956, 28 years after the introduction of command economy!

However, Stalin and his politbureau did not want additional challenges; that of introducing central planning and administration was concentrating their attention strongly enough. Thus, in the period leading to the introduction of central planning, they decided to leave the collectivization of agriculture for the (not too distant) future.

Central planning as a model for the communist economy came—indirectly—from Marxist thinking. Marx himself wrote very little on the future of the communist system that was to “inevitably” follow the collapse of capitalism. Nonetheless he portrayed the evolution of capitalism as a continuous decrease in the number of ever larger private firms. At the end of that evolution was left, presumably, just one firm, ripe for nationalization after the “inevitably successful” revolution.

That logic, or one might say *illogic*, disregarding free entry and competition, led Lenin to stress the ease in managing such mammoth firms. He suggested that a cook, who knows math at the elementary school level, could also manage a firm. Ludwig von Mises, one of the leading lights of Austrian economics, poked fun at Lenin, commenting that it was written by somebody with the mentality of a filing clerk. But, whatever sense of management Lenin had, he was undoubtedly clever enough to be aware of the need of his dictatorial political regime to be firmly in charge of the centrally planned and administered economy.

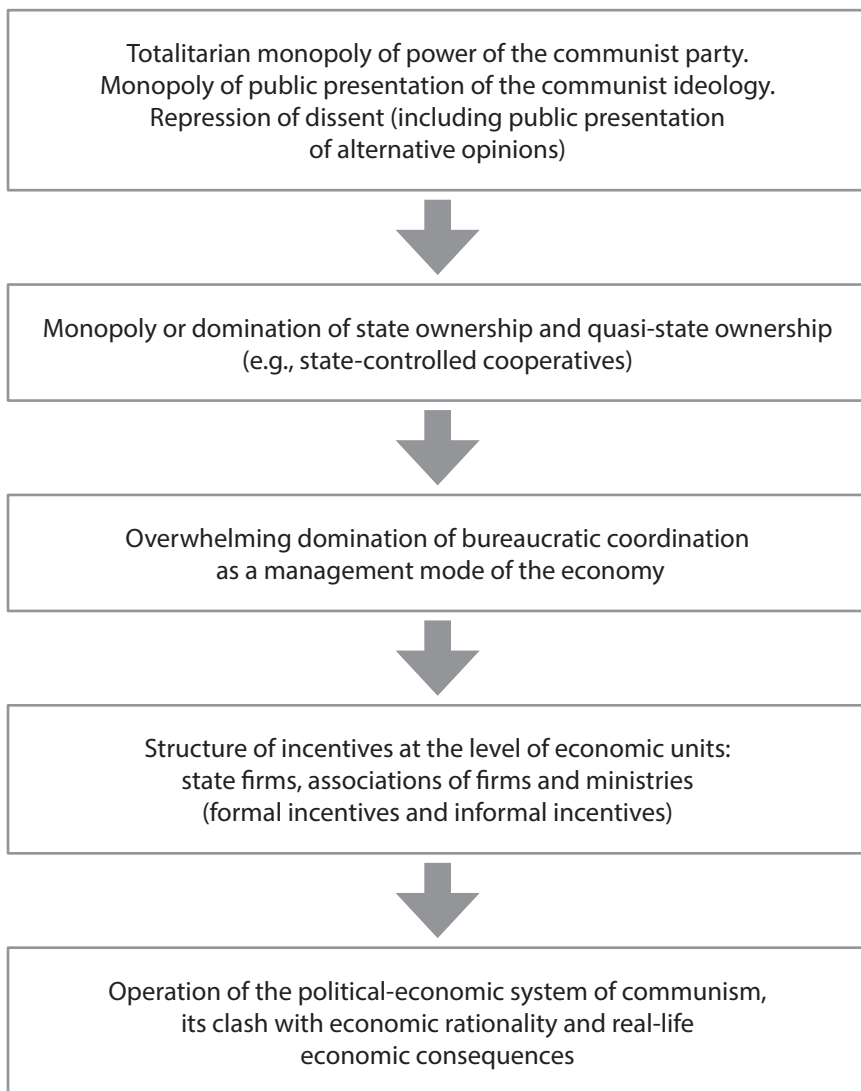
So, central planning started with politics, and throughout its existence political and economic areas remained in a symbiotic relationship. János Kornai rightly stressed the supremacy of politics in that symbiosis—a very un-Marxian practice as it should have been the economic “base” that was to determine the shape of political “superstructure” (and not the other way round).³ In Figure 1.1, a modified Kornai scheme is presented, explaining the origin and nature of command economy. Block 1 at the top stresses not only supremacy, but a full political monopoly of the communist party. No other independent political organizations were allowed to exist. A part of that political monopoly was an ideological monopoly, supported by censorship. More precisely, ideological monopoly did not allow the presentation of even ostensibly communist views if they were not in concordance with the actual twists and turns of the views publicly heralded by the presently ruling leadership.

Historically, when a communist party acquired power it forcibly pursued the nationalization. Block 2 presents the ownership structure of the communist economic system. It was state and quasi-state ownership (e.g., tightly controlled cooperatives) that monopolized production. In some countries small shop-keepers and suppliers of personal services were allowed to exist; in some other they did not. For example, in the Soviet Union and in the former Czechoslovakia even barbers were organized in state firms, employing dozens or even hundreds of barbers.

Once the Marxist ideology-determined state ownership had been established, the decision was taken on the *coordination mode* in the economy. Here, Marx did not say anything decisive. It could have been, then, decided either in favor of market coordination, based on contracts negotiated between parties equal under the law, or bureaucratic coordination based on commands flowing

³ János Kornai, *The Socialist System: The Political Economy of Communism* (Oxford: Clarendon Press, 1992).

Figure 1.1. The communist political-economic system ⁴



from the top to lower echelons. However, Soviet communists did not want to have anything to do with the institutional arrangement called later *market socialism* of the Lange-Lerner-Dickinson type.

⁴ Adapted from Kornai, *The Socialist System*, 361.

More importantly, monopoly—both communist monopoly of political power and economic monopoly (or near monopoly) of state ownership—usually displays strong preference for only one type of relations, that is, relations of subordination. Why allow indirect, market-type coordination of autonomous state units trying to realize goals set by central planners, when it was much easier to establish subordinated state units, listening to commands from the governing center? Block 3 presents, then, the domination of bureaucratic (command-type) coordination as a mode of economic governance.

So, we have, following Kornai's scheme from top to bottom, a triad: political monopoly of the communist party leading to Marxian dogma of state ownership and leading further to a bureaucratic mode of coordination. Blocks 4 and 5 differ markedly from the preceding ones, since they present respectively certain behavioral characteristics of the command economy, explaining how the basic Blocks 1–3 influence the reality of how CPAE operated after its establishment (the three terms: CPAE, CE and central planning are used interchangeably here). Thus, Block 4 looks, for example, not only at the formal structure of incentives, but also at the *informal* one. For choices made with respect to the type of ownership and mode of coordination had very strong impact upon the behavior of state-owned firms, in particular on their managers and workers. And that impact, or economic consequences signaled in the bottom-located Block 5, went far beyond what could have been imagined by those who constructed the system.

Nobel Prize winner Friedrich Hayek distinguished between spontaneously evolving and man-made, constructed, economic systems and observed that the latter are generally crude arrangements because they were never tested in real world. As a result, they produce many (never imagined) *unintended consequences* that appear only when such a man-made construct is put to a test, that is, introduced into the real world. This is also what happened to Soviet-introduced central planning.

Consequences, most characteristic for the system introduced in the Soviet Union and later elsewhere, will be dealt with in the subsequent sections of this chapter. This section will deal only with one important institutional issue: the interaction of formal and informal incentives presented in Block 4. It will be an institutional foretaste of real-life economic consequences.

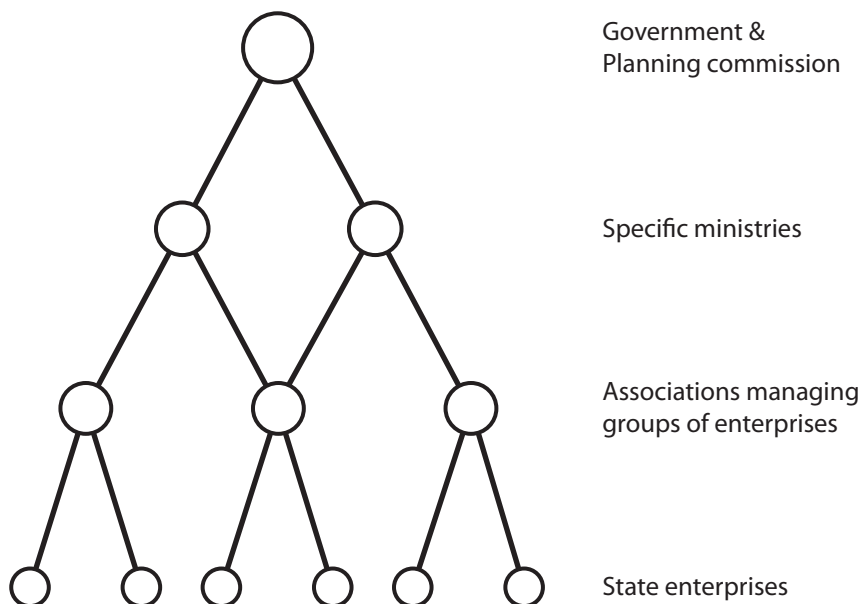
Soviet designers of central planning never presented formally the structure of incentives. But from the directives (commands) central planners formulated with respect to ministries, associations (groupings) of firms, and, finally, individual firms, it becomes clear that they expected these units to behave like private firms in a capitalist market economy. That is, specifically, central planners expected that state firms were supposed to:

- maximize output in terms of its quantity and quality (in accordance with the individualized commands at the firm level in these respects);

- minimize inputs of raw materials, semi-manufactures, as well as inputs of labor and capital (on the general principle of husbanding available resources and production factors);
- minimize inventories in order not to “freeze” too many resources needed elsewhere (such indicators were also included in the plans); and
- generally, they (implicitly) demanded from production units to reduce inputs per unit of output, that is to increase productive efficiency.

What they did not imagine was a lasting impact of fundamental systemic features of the command economy for the behavior of managers and workers in state firms. Very quickly firms—their managers and employees—learned that among dozens or even hundreds of plan indicators (in the centrally planned economy everything had to be planned!) were those more and those less important. And they behaved accordingly. Let us use two examples. They learned from the reactions of their superiors in the planning hierarchy: associations of enterprises, ministries, and the central planning bureau (see Figure 1.2) that quantity of output was more important than quality. Then, the law of unintended consequences began to operate.

Figure 1.2. Stylized vertical planning and the administration pyramid under command economy



There was a dramatic decline in quality. Hungarian historian Iván Berend pored over plan reports from the earliest period of central planning in Hungary and found that, e.g., in light industries quality declined dramatically in the 1950–52 period. To cite one instance, in 1950 intra-firm quality control rejected 1% of shoes planned for export to other communist countries, while a year later that share increased to 25%! In 1952 the share of defected shoes in some factories ranged between 20% and 46%. Similar declines were registered with respect to variety of models of produced footwear. In other light industries producing consumer goods, the pattern was similar. The message was clear and simple: it paid to produce as many units of output as possible in as few varieties as possible and of as low quality as was accepted by state firms' superiors.⁵

It was a case of the clash between formal incentives and informal ones, a clash won with ease by informal incentives. Moreover, it is worth noting that the dramatic decline in quality (in fact, decline in the basic usefulness of output) took place in the period in which the pressure from the Block 1 feature, the supremacy of politics over economics, was the strongest. For example, the Hungarian penal code of the period provided prison terms for managers not fulfilling plan targets: imprisonment up to two years in the case of "ordinary" indicators and up to five years in the case of "important" indicators. However, it was obvious that applying those rules indiscriminately would lead to a complete standstill in the production of just anything. So the rules were applied on an *ad hoc* basis, usually in conjunction with various ideological campaigns pursued by the communist party apparatus.

Even more important for the functioning of central planning was the no less quickly discovered superiority of quantitative output indicators over cost indicators. It transpired soon after the beginning of Soviet central planning that if output indicators were fulfilled by state enterprises, then the management and workers could be sure that they would be rewarded with bonuses and premiums even if these enterprises exceeded planned production costs. In fact, they were rewarded even if costs exceeded the monetary value of produced output.

In this manner, "hard" commands to produce certain quantity (reinforced by the threat of prison terms in case of failure), were accompanied by what Kornai called the "soft budget constraint."⁶ The term, popular among Sovietologists, meant the nonexistence of a threat of bankruptcy resulting from financial failure. Under normal capitalist market circumstances excess of costs over revenues, especially when repeated, would force the firm to exit. But bankruptcy did not exist in the vocabulary of CPAE. The worst that could (rarely) happen would be a merger with another state firm, manufacturing similar range of products.

⁵ Iván Berend, *The Hungarian Economic Reforms, 1953–1988* (Cambridge: Cambridge University Press, 1990), 10–2.

⁶ János Kornai, "Resources-constrained Versus Demand-constrained Systems," *Econometrica*, vol. 47 (1979), no. 4, 801–20; János Kornai, *Economics of Shortage* (Amsterdam: North Holland, 1980).

From where did this economically most corrosive system-specific characteristic come? Why did designers and implementers of the command economy accept such behavior? The most popular explanation seems to be the reference to the Marxian utopia of “producing for needs, not for profit.” After all, what people need was goods (and services), not money, in which excessive costs were expressed. Thus, if goods were delivered, the plan seemed fulfilled with respect to its most important indicator. What they, and many others, did not understand was the attendant waste. More resources, in terms of value, were often put into the product(s) than producers and/or consumers received with a given product. It was the *destruction of wealth*, not wealth creation (see for other than communist economies a similar line of thinking by William Baumol).⁷ It was the beginning of the “great divergence” between output growth and the growth of well-being, unknown in the capitalist market economy. It is worth noting in this respect that the foregoing issues were rarely—if ever—considered by statistical experts comparing communist and capitalist economies (see below).

The explanation offered above is not the end of the story, but just the beginning. The clash between formal and informal incentives and the triumph of the latter happened for two reasons, not discussed among central planners and their political masters:

- lack of private property and its structure of incentives, encouraging firms to produce economically (that is to strive for the largest possible excess of revenues over costs); and
- lack of market competition that would balance incentives with threats of failure in case of the prolonged inefficiency relative to other competitors.

However, the problem with the offered diagnosis was that it pointed to the wrong choice of the type of ownership and of coordination mode, made by the ruling political monopoly (see Block 1 in Figure 1.1) with respect to basic features of central planning presented in Blocks 2 and 3 in the figure in question. Such interpretation was too dangerous to even contemplate and therefore was not discussed during the numerous reforms of the communist economic system until the last years of system’s existence.

Multiple Distortions Stemming from the Soft Budget Constraint

Soft budget constraint, that is the lack of a threat of bankruptcy due to financial failure, was at the root of many if not most, distortions of the system. Take into account, for example, demand signaled by enterprises. Since resources required

⁷ William J. Baumol, “Entrepreneurship: Productive, Unproductive, and Destructive,” *Journal of Political Economy*, vol. 98 (1990), 893–921.

(inputs, capital investment, labor employed) came for state enterprises as a free good of sort, their managers constantly demanded more and more of them in full knowledge that cost overruns would be validated by their superiors. In that they were supported by the preference of planners for gross output indicators rather than value added ones.

It was profitable for state firms, then, to use more costly rather than less costly material inputs because it helped to fulfill gross output value indicators more easily. Add to the above the stressed preference for quantity output indicators over cost-related (financial) ones and an explanation of the unwillingness to innovate to reduce costs becomes obvious: innovation interfered in current production, reducing the probability of fulfilling quantitative output plan targets. Therefore, state firm managers tried to avoid innovation as long as they could without risking their job (or even freedom). A consequence of all these unintended consequences of the system was a very high resource-intensity of production in communist countries as evidenced in Table 1.1.

Table 1.1. Resource intensity of East European communist economies and selected West European capitalist economies in 1979–80 (measured by per capita consumption of energy and steel per \$1,000 of GDP^a).

Country	Energy in kg of coal equivalent	Steel in kg
Communist East^b		
Bulgaria	1,464	87
Czechoslovakia	1,290	132
Hungary	1,058	88
GDR ^c	1,356	88
Poland	1,515	135
Soviet Union	1,490	135
Average (unweighted)	1,362	111
Capitalist West		
Austria	603	39
Belgium	618	36
Denmark	502	30
Finland	767	40
France	502	42
Germany	565	52
Italy	655	79
Norway	1,114	38

Country	Energy in kg of coal equivalent	Steel in kg
Sweden	713	44
Switzerland	371	26
United Kingdom	820	38
Average (unweighted)	660	42

Notes: a: US\$ of 1979; b: except Romania; c: Communist part of Germany.⁸

Please note that the lack of concern about financial indicators had highly adverse aggregate effects on the planners' cherished output quantity indicators. If all firms used more raw materials and semi-manufactures than under the capitalist market conditions, lower quantity of output could be generated from the same amount of resources. In fact performance was worse than that. Not only was more inputs used to produce the same amount of GDP as it was in capitalist market economies, but also more inputs were "frozen" in overlarge inventories. The ratio of inventories to GDP fluctuated in 1970s and 1980s in four communist economies (Soviet Union, Czechoslovakia, Hungary, and Poland) between 65% and 80%, while at the same time it was equal to 30–33% in the United States.⁹ It is worth noting that the 2.0–2.5:1 ratio of resource intensity in Table 1.1 was roughly repeated in the case of inventories/GDP ratio. Clearly, with such high margin of waste, the communist propaganda slogan "*obgonit' and pieregionit*" (from Russian: "catch up with and surpass") capitalist economies looked, indeed, highly difficult to implement.

All the more so, as the command economy was afflicted—as I signaled already above—by other distortions, driven by the non-existent threat of bankruptcy for state firms. With all state firms behaving in the above manner, aggregate excess demand appeared early in Soviet planning and became an inseparable characteristic of communist economic system till its very end.

It is worth noting that excess demand did not result from the physical scarcity of inputs. Communist state firms used more inputs per unit of output than their capitalist counterparts. Also, more of these inputs were "parked" in inventories of state firms than in inventories of their Western counterparts. Physically, the resources were there. Why, then, under central planning did excess demand and shortages dominated the picture?

⁸ Source: Jan Winiecki, *The Distorted World of Soviet-type Economies* (London: Routledge, 1988), 7; and sources quoted therein.

⁹ Jan Winiecki, "An Inquiry into the Early Drastic Fall of Output in Post-communist Transition: An Unsolved Puzzle," *Post-Communist Economies*, vol. 14 (2002), no. 1, 13.

I stressed the following five reasons:¹⁰

1. Resources simply did not exist in reported quantities (a point to be explained in a moment).
2. Resources were not of the required quality. As quality was disregarded by managers and workers, a part of delivered quantities was not usable and firms demanded an equivalent quantity from higher levels of the planning hierarchy (obtaining them or not, depending on availability and priority of a given type of output).
3. Resources were not of the right type. Suppliers were interested in producing as narrow a variety of types and sizes as possible and, therefore, user firms had extra problems with adjusting, say, thicker steel plate to the required thinner plate at some cost in time and money (an unacceptable alternative would be not to produce at all!).
4. Resources were not delivered at the right time. State firms had their annual, quarterly and monthly plans and it mattered whether some inputs were delivered when they were needed or weeks or months later. In the climate of pervasive excess demand state firms did not care much about the timeliness of deliveries (as long as their own plans could have been reported as fulfilled).
5. Finally, resources were not available at the right place. It did not matter much for state firm A that the urgently required inputs were stored, and left unused, in inventories of state firm B. There was no mechanism to relocate them where they were needed. Thus, shortage could—and did—persist also under the circumstances of aggregate excess supply!

Now, in explaining the first of the foregoing reasons for the domination of excess demand, I should add yet another endogenous, system-specific feature, namely *informational asymmetry*. It is, of course, a more general economic feature, but under the institutional framework of central planning it became pervasive in relations between the levels of the planning pyramid (see Figure 1.2). In the economic system without markets, output is not verified by actual sales in these markets. It is simply reported upward to higher levels in the hierarchy. This creates unlimited opportunities for doctoring the reports. The issue had been stressed by numerous economists within the Soviet system and in the West.

Here is where informational asymmetry comes in. Higher levels in the hierarchy knew much less than enterprise management what the actual quantity of output was that (a) could be produced at a given level of supplies; and (b) was actually produced in a given planning period. In fact, it knew much less about almost any feature of enterprise activity. In consequence, doctoring reports was rampant.

¹⁰ Winiecki, *The Distorted World*, 4–6.

The most typical was what was called *pripiski* (“write-ins”) in the Soviet Union, that is, simply reporting higher output than was the case in reality. At the turn of 1970s and 1980s the Soviet Committee for National Control reported to the politbureau and central planning office that such write-ins were discovered in every third enterprise. However, with informational asymmetry in favor of state firms, it may be safe to assume that undiscovered *pripiski* were at least as frequent as those discovered by state control’s bureaucrats. And let us add that other forms of doctoring reports were also used frequently in state firms. After all, there were many plan indicators worth doctoring to the advantage of the firms!

An inquisitive reader may begin to wonder why, in spite of informational asymmetry in favor of state firms, the higher ups could not exert somewhat stronger degree of oversight. There were associations of enterprises producing a similar range of goods, then ministries and, finally the central planning bureau. At one level or another of the planning pyramid one could expect some more detailed reviews of submitted enterprise reports.

The nature of the planning pyramid prevented, however, such—otherwise reasonable—endeavors. An association of enterprises was interested in reporting as high as possible aggregate outcome of a group of state firms it supervised because they were evaluated by their superiors on the basis of submitted aggregate reports. So, it was not interested in verifying reports of individual enterprises because such verification could be—they might suspect rightly—only in the downward direction. Similar calculations prevailed in ministries supervising associations of enterprises.

In actual fact, it was only the center—central planning bureau—that had an interest in revealing the true situation with respect to all important indicators (with output quantity in the first place), with every other level in the planning hierarchy playing against the center. Formal superiority in the planning hierarchy, with all its might of issuing commands to lower levels and demanding from them (in principle truthful) reports, could not prevent making central planning bureau the least informed unit with respect to individual state firms.

Economic Development Strategy under Central Planning

Although central planning was the centerpiece of the communist economic system established in 1928 and pursued (with some, rather minor, modifications) until the very end, it is obvious that Soviet planners and their political masters in the politbureau must have had an idea of how the Soviet economy should look like in 10–20 years. According to Karl Marx, the economy after the communist revolution should be the most developed in the world. The “inevitable revolution” was to take place, when there would be left just one (or at most a few) very large capitalist firms, which were to be subsequently nationalized. But the issue of developmental strategy aimed at catching up with the most developed countries after the “inevitably successful” revolution was never raised in his writings.

However, Marx imaginings apart, the reality of Soviet Russia was clearly different. After all, Lenin and later Stalin and their underlings understood quite well that the country they ruled was not the most developed in the world. Therefore, the issue of how to get to the top of the economic development league must have been quite important for them. In their second try, they decided on the economic system, sharply different from that prevailing in the world. Their decision solved the question: “How?” The answer was: “Via central planning.” An answer to another question: “Where to?” was regarded as obvious: first, to become like the most developed countries in the world, that is “to catch up,” and next “to surpass,” in accordance with the well-known slogan. Economic development strategy should help in mapping the route from here to there.

To be like the most developed countries in the world meant for Soviet planners to reach the industrial output level and structure of such countries (say, United States, United Kingdom, Germany). With respect to output structure, it should be the structure with the dominant heavy industries: coal production, electricity, steel making, metal products, machinery and transport equipment, bulk chemicals—all seen at the time as the pinnacle of manufacturing production and a symbol of industrial might.

They wanted to reach such a sophisticated structure as fast as possible to become independent of critical industrial supplies from the most developed West (portrayed moreover in official propaganda as their worst enemy). If such developmental choices were combined with the rigid central planning system, it was clear that the strategy would be almost autarchic, amounting to the extreme version of inward-oriented, import substitution strategy.

In turn, moving as fast as possible meant allocating as many resources as possible to these modern branches of industry, which promised many lean years for the production of consumer goods, desired by the already long-suffering population. The strategy was not impossible to implement from the financing perspective. Every totalitarian monopoly has enough power to impose upon politically disenfranchised population a very high (forced) savings rate required for investment.

Soviet strategy was then called a *steep ascent* strategy. The steepness reflected the shortcut taken by the central planners in changing the industrial, or more importantly manufacturing, output structure. Various studies generalized on the spontaneous evolution of manufacturing from light to heavy industries and changes in the level of product sophistication within various industries as economies raised their GDP per capita (more about it in Chapter 2 on development economics-based strategies).

Spontaneous evolution takes time, though, while Soviet planners had been in a hurry (also because of their political obsession of military threat from the West). Therefrom came the steep ascent, that is, a concentration of resources on the most modern industries, at the cost of underinvesting in other, historically earlier expanding industrial branches.

Such a strategy in itself augured distortions in the output structure. But another problem arose (unnoticed for decades). Developmental strategy had been designed with the large, autarchic Soviet economy in mind. With the Soviet domination over Eastern European countries from Poland in the north to Bulgaria in the south, the strategy was (obligatorily) replicated by communists ruling there. Yet the latter group of countries was composed of relatively small countries, the natural beneficiaries of the international division of labor and outward-oriented developmental strategy. Imposing near-autarchy on such countries added substantially to their structural distortions. Near-autarchy should be properly understood, though. These economies traded with each other and to a smaller extent with the rest of the world, but without taking part in international specialization.

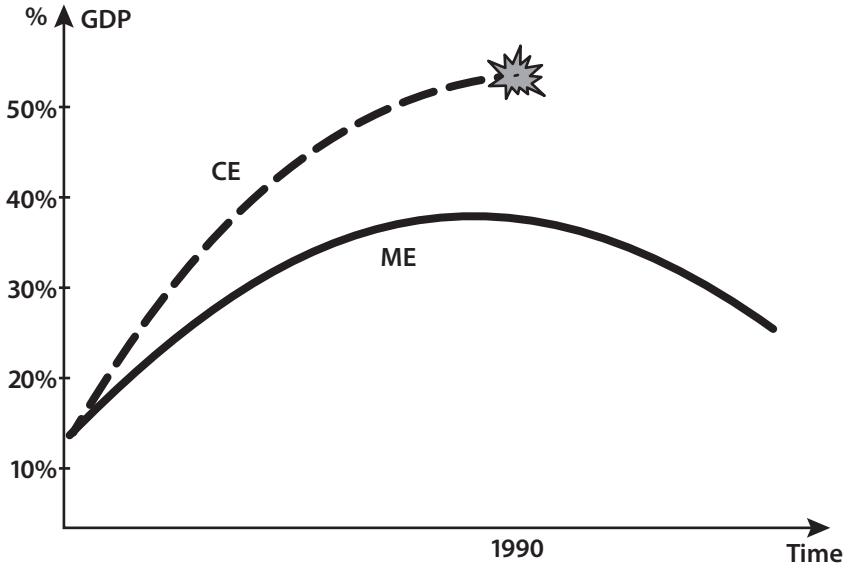
More importantly for the evaluation of the system and strategy in their mutual interaction, both contributed to the creation of output (and employment) structure that became a distinct outlier in the history of economic development. It is well-known from empirical studies that at an early stage of industrialization the share of industry in large countries grows faster than in smaller ones. The reason is simple. Even at a low level of GDP per capita there may be enough demand in the aggregate for, say, iron and steel, so the iron and steel and other scale-based industries develop profitably at a rather early stage of development (as, e.g., in India). The same cannot be said about smaller countries, where such industries face the limits of aggregate demand for their products. So, many industries develop there later, at higher stages of economic development, usually in conjunction with their international specialization.

In the case of smaller European communist economies, the pursuance of near-autarchic steep ascent strategy, additionally without such specialization, created an overgrown industrial sector throughout the communist world. Figure 1.3 presents a sharply different pattern of change in the share of industry in GDP and employment vis-à-vis the group of developed and developing market economies. In the latter, the share of manufacturing industry grows with the increase in GDP per capita until it stabilizes, usually between 30–40% of GDP and employment, and later begins to decline. Not so in communist economies. There, the share of industry grew both earlier and reached a higher share (on the average between 40% and 50%).

An interesting point is that also in the case of Soviet Union, the only large economy in the group, the share of industry displayed the same oversized characteristic. My own inquiry proved that structural distortions result from both autarchic strategy and system-specific features. Excessive shares of industry registered by smaller communist economies were in part the result of their inward-oriented, autarchic developmental strategy. But it was a smaller part. Much larger part resulted from yet another, system-specific, that is endogenous feature, which I called “do-it-yourself” strategy of state firms.¹¹

¹¹ Winiecki, *The Distorted World*, Chapter 3.

Figure 1.3. Stylized pattern of changing shares of manufacturing in the process of economic development in market economies (ME) vs. pattern in communist economies (CE) until their end in the 1989–91 period



State firms operated in the environment of a high level of uncertainty of supplies. I stressed that inputs might not come at all, or they might come in wrong sizes and/or types, or they were of too low quality, or did not come on time. Under such circumstances a defensive strategy of a firm was to produce as large a part of inputs as possible in their own firm.

It made microeconomic sense for a given firm, but at a cost of sharply aggravating macroeconomic imbalances. Firstly, it increased cost of inputs, depending on the level of sophistication of industry, from 30–40% to 600–700% relative to costs registered by a specialized supplier of such inputs (calculated from Soviet data in the 1970s and early 1980s). Secondly, a part of increased costs resulted from less efficient use of materials, which added to excess demand for inputs. Altogether the do-it-yourself strategy was a costly experiment in *despecialization*.

One more comment is in order at this point. I noted that state firms operated under a high level of uncertainty. One almost hears the laughter of history. After all Marx and his followers explained the need to nationalize the private firms and replace the capitalist system by the communist one in order to eliminate the “anarchy of the market.” After introducing central planning it soon transpired that anarchy of planning with its permanent uncertainty about

supplies is very much worse than fluctuations in the capitalist market. The best insurance to obtain a particular input or a machine on time and of good quality was to get a permit to buy it in the Western market economies.

To complete the range of determinants of high uncertainty in the planned and administered economy let me turn now to capital investment. Developmental strategy required expansion of production in general and expansion of production in the preferred heavy industries in particular. Under central planning investments were also planned. The starting point was the five-year investment plan (FYP for short), which was later disaggregated into annual investment plans. And it was the process of FYP creation and later of its implementation that—under the impact of revealed system-specific distortions—were yet another source of economic turbulence in the system. Five-year investment plan became *the* major factor of fluctuations in the level of excess demand and shortage.

In practice, the level of excess demand was increasing and decreasing over time, displaying certain regularities in this respect. These regularities were associated with what some economists called *the investment cycle*.¹² The stylized pattern of a typical investment cycle looked as follows.

- Central planners prepared (and politbureau approved) a draft of a five-year plan concerning capital investment. At that level of generalization it could only be a financial plan. It stated how much money—taking into account the developmental preferences of central planners—ministries were to spend on investment. At this point the planning pyramid began to move. Ministries divided planned sums between subordinated associations and, then, associations began to divide their sums between subordinated firms.
- That was not, however, the end of the story, but only the beginning. The existence of informational asymmetry enabled state firms to enter into informal bargaining with their superiors. Informal, because formally what came from above was a command to be implemented, pure and simple. Thus, firms that wanted to get as many “free goods” (investments, labor, inputs, etc.) as possible made requests in this respect, which by far exceeded what was planned for a particular investment project. Thanks to their superior knowledge of what was needed to implement the investment project with the least effort, they often succeeded in convincing their superiors. And, as stressed above, superiors also wanted to help “their” firms to easily fulfill plan targets; so ministries often played the same game.

¹² See, in particular Tamás Bauer, “Investment Cycles in Planned Economies,” *Acta Oeconomica*, vol. 21 (1978), no. 3, 243–60; Jan Winiecki, “Investment Cycles and Excess Demand Inflation in Planned Economies: Sources and Processes,” *Acta Oeconomica*, vol. 28 (1982), nos. 1–2, 147–60; and Igor Birman, *The Economy of Shortages* (New York: Chalidze Publishers, 1983).

- The effect of multiple bargaining games was such that the investment FYP returned to the top much larger in financial terms (sometime double the original size). The central planners could not accept such an increase in capital investment; a promise of some increase in consumption should also be included into the FYP for propaganda reasons. So, they ordered sizable cuts down the line. These cuts had to be put in percentage terms (they did not know even the approximate costs of individual projects, with the exception of a few major ventures like a new steel mill, for example).
- The finally accepted plan, after ordered cuts, started, however, with two in-built distortions:
 - (a) although firms wanted as many “free goods” as possible, with respect to their individual pet projects state firms usually hid from their superiors real (mostly higher) aggregate costs of implementation and demanded less than was really needed to implement such a project over a number of years in order not to put off higher level authorities); and
 - (b) this hidden imbalance was further aggravated by the uniformly applied cut by central planners, which increased the gap between planned and real cost of a given investment project.

These distortions began adding to the excess demand and shortage from day one of the plan’s implementation. At the beginning, in the first year of the FYP, this additional demand did not manifest itself too strongly; it was barely distinguishable in the overall climate of excess demand and shortage. Usually, however, in the second year it became increasingly obvious that demand for financial and real resources was increasing, while the level of project completion in real terms was much behind the plan. Moreover, the imbalance in the producer goods sector spilled over to the consumer goods sector. After all, workers in the former earned more in overtime work, and employment increased as well. As a consequence, the scale of the imbalance between rapidly increasing demand and slowly or not at all increasing supply of consumer goods began to grow fast.

The peak of excess demand usually emerged in the third year of the plan. The fast growing demand for raw materials, semi-manufactures, machinery, and equipment signaled the exploding imbalances. The spillover to the consumer goods market not only increased the imbalances there, but also increased the dissatisfaction of the population—with growing consumer dissatisfaction and a probable negative feedback to workers’ productivity.

At that point central planners and their political masters usually decided to slow down the investment growth rate and reallocate some resources to investment in consumer goods and to the increase in their current production. An interesting feature of the process is that central planners only at that late stage were able to undertake some—of course, not all—decisions in real, not only financial terms. They could decide which projects should continue unchanged,

which would temporarily be mothballed, and which (very rarely) were to be discontinued altogether. These decisions were, however, made with the policy priorities, not economic efficiency in mind. What mattered most was how much various projects coincided with planners' developmental priorities.

After the changes, the last two years of the FYP resulted in reduced level of excess demand. Shortages became less ubiquitous and painful for the consumers. However, in the fifth and last year of the FYP, the central planning bureau began working on the next five-year plan for capital investment and the whole cycle started anew.

What is worth stressing with respect to the investment cycles is the following. First, rarely (if ever) were excess demand and shortages completely eliminated nor did the command economy become balanced—even for a short period. Shortages were so inseparable under the communist economic system that Kornai wrote about the “normal level of shortage” accompanying such economies. Variations from that normal level—up or down—resulted from investment cycles and large one-off disturbances.¹³

Second, one should underline the difference between business cycles in capitalist market economies and investment cycles in communist ones. Joseph Schumpeter applied to the recessions in the former the term: *creative destruction*. In recessions—he pointed out—the worst firms exit the market, better ones take a larger share of aggregate output, while new entrepreneurial firms take chances and enter the market. In other words, the average quality of firms in a given economy improves and makes the economy better prepared for the next cycle.

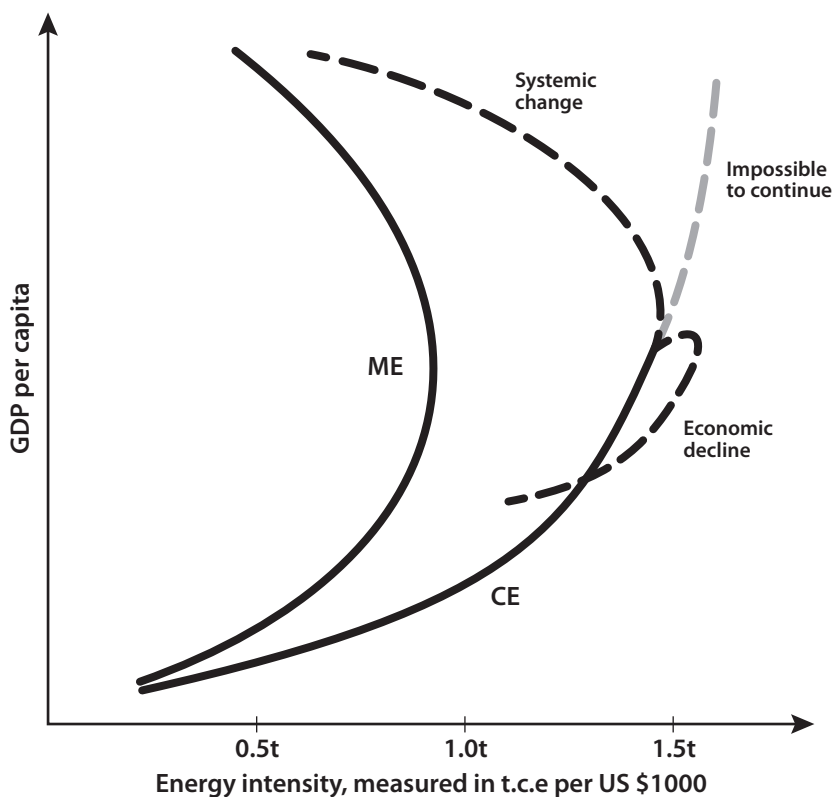
Nothing similar happened in command economies. The selection of projects to be mothballed or discontinued was made by central planners on the basis of their political importance, not economic efficiency. Bad performers were not eliminated and the command economy entered the next investment five-year planning period at the same level of performance, with the same built-in endogenous distortions, as in the preceding cycle. The only positive effect, that of reducing excess demand and shortages, was only temporary and economic disturbances would reemerge again in the first or second year of the new FYP. Excess demand and shortages were self-reproducible with each investment cycle (see Figure 1.4).

Central planning reminded the torture of Sisyphus, pushing with great effort his stone up only to see it slipping down again. Gregory Grossman, one of the most knowledgeable analysts of the command economy, wrote something similar. He stressed that planners try to use most rudimentary measures in their (fruitless) efforts to keep the semblance of balance in their economy, a feature the market displays almost effortlessly.¹⁴

¹³ János Kornai, *Growth, Shortage and Efficiency* (Oxford: Blackwell, 1982).

¹⁴ Gregory Grossman, “Notes for a Theory of the Command Economy,” *Soviet Studies*, vol. 15 (1963), no. 2, 101–23.

Figure 1.4. Changes in GDP per capita in capitalist market economies (ME) and communist economies (CE) at different GDP per capita levels in relation to energy intensity (solid lines). Alternative future paths of GDP per capita and energy intensity available to CE (dashed lines).¹⁵



A permanently unbalanced economy, suffering from the multiple distortions noted above, continued to display a high level of uncertainty. Planning, in spite of its appearance of order and predictability, continued to be a hazardous business. An interesting study made by two Polish economists presented the results of research on the exact plan implementation in Polish planning. The authors studied the annual plan implementation of 182 plan indicators over a

¹⁵ Source: Jan Winiecki, *Economic Prospects: East and West* (London: Centre for Research into Communist Economies, 1987), 25.

period of three successive FYPs. The results were shocking for the uninitiated, but unsurprising for the students of central planning.¹⁶

With defining exact plan implementation as being in the range of 99%-to-101% of the plan target, only 19.3% of cases qualified as exact implementation of a plan indicator! Deviations, both up and down, between 1% and 5% took place in 41.6% of cases, while those higher than 5% in 39.1% of cases. More details can be found in Table 1.2.

Table 1.2. The pattern of deviations of actual from planned and predicted production-related indicators in Poland in 1961–76

Range of deviations in percentages	Deviations from the plan	Deviations from the prediction a
The percentage of cases within a given range		
0–1	19.3	36.6
1–2	14.2	19.7
2–3	11.5	11.3
3–4	8.4	6.9
4–5	7.5	4.6
5–6	5.7	3.6
6–7	4.9	3.4
7–8	3.5	1.7
8–9	3.0	2.4
9–10	3.0	1.7
10 and more	19.0	8.1

Note: Predictions were prepared every year in September¹⁷

Additionally, the level of uncertainty faced by planners can be seen from the third column of figures in Table 1.2. Every year in September central planning office conducted an assessment of the probable level of plan implementation. And even at that late date the predictions of exact implementation amounted only to 36.6% of the total (within the same definition: 99%-to-101% of a plan figure). And Poland was a standard rather than an exception as suggested, e.g., by a survey of less comprehensive Soviet data from late 1970s.¹⁸

¹⁶ Wojciech Maciejewski and Józef Zajchowski, “Problemy Analizy Wykonania Planu” [Analysis of Plan Implementation], in *Informacyjne problemy planowania* [Informational Problems of Planning], ed. Wojciech Maciejewski (Warsaw: PWN Publishers, 1982), 211–37.

¹⁷ Source: *Ibid.*, 236.

¹⁸ Details in Winiecki, *The Distorted World*, 14.

The World of Make-Believe: Propaganda Image and Reality in the Economic Development of Communist Command Economies

Some older readers, especially those who looked at official communist statistics themselves, may feel a bit perplexed. After all, they remembered impressive economic growth statistics of the Soviet Union and smaller East European communist countries. These statistics were also reproduced by international bodies, e.g., in the UN statistical yearbooks. Were they all lies? In the sense of an old joke about three kinds of lies: “lies, damned lies, and statistics,” they were.

They were doctored at the bottom of the planning pyramid, that is, by state firms reporting to their higher ups. They were doctored at times additionally at the top, to make figures look even better or for other reasons. For example, Soviet deputy head of the Goskomstat (central statistical office) admitted in early 1990 at the conference in Airlie, Virginia, that Soviets did not include in official statistics four million manufacturing workers in the machinery and equipment industry. The idea was, presumably, to hide from the West the size of Soviet military sector-oriented engineering production.

The foregoing and other distortions made the official statistics to deviate sharply from the (unknown) reality. And deviate to an ever larger extent as problems generated by the economic system accumulated over time. Table 1.3 presents some evidence on GDP growth rates concerning Soviet Russia. Even from the limited selection of alternative assessments of Soviet economic growth it transpires that actual economic growth was markedly lower than the official one – and the Soviet economy has been *de facto* stagnant since mid-1970s. The stagnation was followed by the collapse at the turn of 1980s and 1990s.

Table 1.3. Official Soviet statistics and some other estimates of Soviet economic growth rates in 1961–85 (annual averages for five-year periods in %)

Period	Goskomstat	CIA	Unofficial Russian a
1961–65	10.2	...	7.2
1966–70	6.5	5.1	4.4
1971–75	5.7	3.7	3.2
1976–80	4.2	2.6 <i>b</i>	1.0
1981–85	3.5	... <i>b</i>	0.6

Notes: a—study made in the Novosibirsk unit of the Soviet Academy of Sciences; b—a later CIA study presented for 1976–80 an average 2.3% annual rate, while for the 1981–85 an average 1.9% rate.¹⁹

¹⁹ Source: Winiecki, *Economic Prospects*; and sources quoted therein.

There were of course intermediating variables, like long term swings in fuels and industrial mineral prices. Yegor Gaidar, in a book published shortly before his premature death, noted that the 1980s, the last full decade of the Soviet Union's existence, was the decade of falling fuel prices, which aggravated the problems of the increasingly ossified Soviet economy.²⁰ But it is worth noting that both official and unofficial figures on economic growth in 1970s also record declining growth rates. They strongly suggested that additional resources obtained from oil and gas exports were not able to help much the economic system dogged by a variety of endogenous distortions, discussed in the sections "Multiple Distortions..." and "Economic Development..." above. Thus, stagnation in question cannot be attributed to declining fuels' prices alone.

There were some serious scholars who accepted at face value the official Soviet and other communist statistics. The real debate was, however, going on among those who quarreled about the best methodologies of correcting (downward) the official figures. There is a highly valued lineage going from Abram Bergson, to CIA analysts' basic methodology to statistical authorities of the present (like Angus Maddison, Bart van Ark, and others) who applied the AFC (adjusted factor costs) method—with its proposed corrections—as the best way to recalculate communist economic statistics. See, for instance, Angus Maddison's statement that "the CIA estimates of Soviet growth performance [...] are the best documented and most reasonable estimates we have."²¹

However, many practitioners criticized the methodology in question, mostly for its range of upward biases. During the already quoted Airlie conference, independent participants from Russia (other than the delegation of Goskomstat) pointed repeatedly to numerous upward biases of the CIA estimates. This criticism reverberated in the Sovietological literature, as e.g., in Anders Aslund's well-known essay.²²

Instead of joining the general debate, I prefer to point out to some specific evidence of the upward biases stemming from my own research. There is, then, incontrovertible evidence that the distance—technological and economic—from the West not only continued to be large, but also tended to *grow over time*. For example, data on Soviet exports of engineering goods over the 1965–85 period showed declining attractiveness of Soviet machinery and equipment. Measured in kilogram prices obtained by Soviet exporters in the European Union, divided by prices obtained by all exporters to the EU, the former got in 1965 only less

²⁰ Yegor Gaidar, *Anomalie wzrostu gospodarczego* [Anomalies of Economic Growth] (Warsaw: CASE, 2000).

²¹ Angus Maddison, "Measuring the Performance of a Communist Command Economy: An Assessment of the CIA Estimates for the USSR," *The Review of Income and Wealth*, vol. 44 (1998), 322.

²² Anders Aslund, "How Small Is Soviet National Income," in *The Impoverished Superpower: Perestroika and the Soviet Military Burden*, eds. H. S. Rowen and C. Wolf (San Francisco: Institute of Comparative Studies, 1990), 13–62.

than half (46%) of the average prices obtained by all exporters for the same (engineering) goods. Yet 20 years later they obtained barely 23%! In fact declining competitiveness characterized all East European command economies.²³

The picture, one of an obvious failure, emerges from the survey of the command economy, interacting with Soviet-style steep ascent developmental strategy. So, again, wherefrom came impressions of an outstanding success, so often found among those sympathetic to the system in the West, as well as in less developed countries? Doctored statistics did help a lot with naturally credulous Westerners. Economic historian Eric Jones stressed that “over shorter periods other systems [than market capitalism], such as centralized or centrally planned ones, may do better and certainly may *seem* to do better.”²⁴

“Seemingly” doing better in Eric Jones’s terms refers to “lies, damned lies, and statistics” in the quoted joke. Really doing better is a different story. If a highly centralized system of a command economy had historically any advantage over a decentralized capitalist market economy, it had been the ruthless, rapid amassing of resources needed for economic expansion, regardless of the preferences of the population, and then allocation of these resources over a relatively small number of large-scale investment projects. Relatively rapid, even if very costly, implementation added substantial new capacity and allowed to rapidly increase production.

One more factor needs to be added, though, to the foregoing statement. These large projects should positively correlate with the dominant output structure. Only then, their contribution to economic growth would have large impact. And, indeed, this is what had been observed in 1950s and 1960s. The decades in question were the closing ones of the period, when the engine of growth in the world economy consisted largely of industries based on the economy of scale: iron and steel, cement production, bulk chemicals, and the like.

Expansion of scale-based industries in the Soviet Union and its communist dependencies took place on a large scale in these decades. Increase in output was impressive and so was nominal economic growth. It was at that time that Westerners and “Third Worldists” looked at these countries’ performance with appreciation and some Westerners even with apprehension. They must have taken seriously Soviet leader, Khrushchev, late 1950s boasts of forthcoming “catching up and surpassing” the West economically. Just like the Polish socialist, co-author of “market socialism” theory, Oskar Lange, who wrote in early 1960s that the West soon would install a new Iron Curtain so that Western workers could not see higher living standards of East European workers. Even fine minds may become afflicted by their own pet delusions.

²³ Elisabeth Winiecki and Jan Winiecki, *The Structural Legacy of Soviet-type Economies: A Collection of Papers* (London: Centre for Research into Communist Economies, 1992).

²⁴ Eric Jones, *The Record of Global Economic Development* (Cheltenham and Northampton, MA: Edward Elgar, 2002), 45.

Reality was different. In those years economic growth was high. Markedly lower than official figures, due to *pripiski* and other shenanigans perpetrated under central planning, but relatively high nonetheless. However, central planning had been a unique economic system, where there was little correspondence between economic growth and economic well-being (I avoid the term “welfare” as it acquired a different and to me not necessarily positive meaning). Actual increase in private consumption could be a half, a quarter, or a tenth of GDP increase.

Thus, there is a clash between the impression that Soviet and other East European economies grew very fast, rapidly catching up with the West, and the reality. First of all, there was lack of correspondence between growth and well-being (measured by private consumption), signaled in the preceding paragraph. But there were other factors, too. Catching up in terms of GDP per capita by communist countries was officially registered, but had not necessarily occurred in reality due to hidden inflation counted as output growth. Downward correction of actual level of GDP per capita was necessary for that very reason alone.

But that was not the end of downward corrections. Not only a quantitative correction was necessary, but also a qualitative one. From export statistics quoted in this section it is clear that goods produced under the command economy were not only of lower quality, but also of increasingly lower quality. So, it is not at all obvious that even in the best period for command economies (1950s and 1960s), they indeed much reduced the developmental distance to the West. Clearly, studies, such as, e.g., that of Martin Cave and Paul Hare seem to have taken the appearance for reality in their laudation of “impressive” achievements of central planning in communist Europe.²⁵

Afterwards it was only worse—and, again, increasingly worse. The 1970s were the watershed between the earlier period of domination of scale-based industries and the next one, where the role of growth engine shifted to those industries characterized by entrepreneurship, with its old and new features of innovation, flexibility, quality, and customization (including after-sale servicing). However, these features were an anathema for central planners.

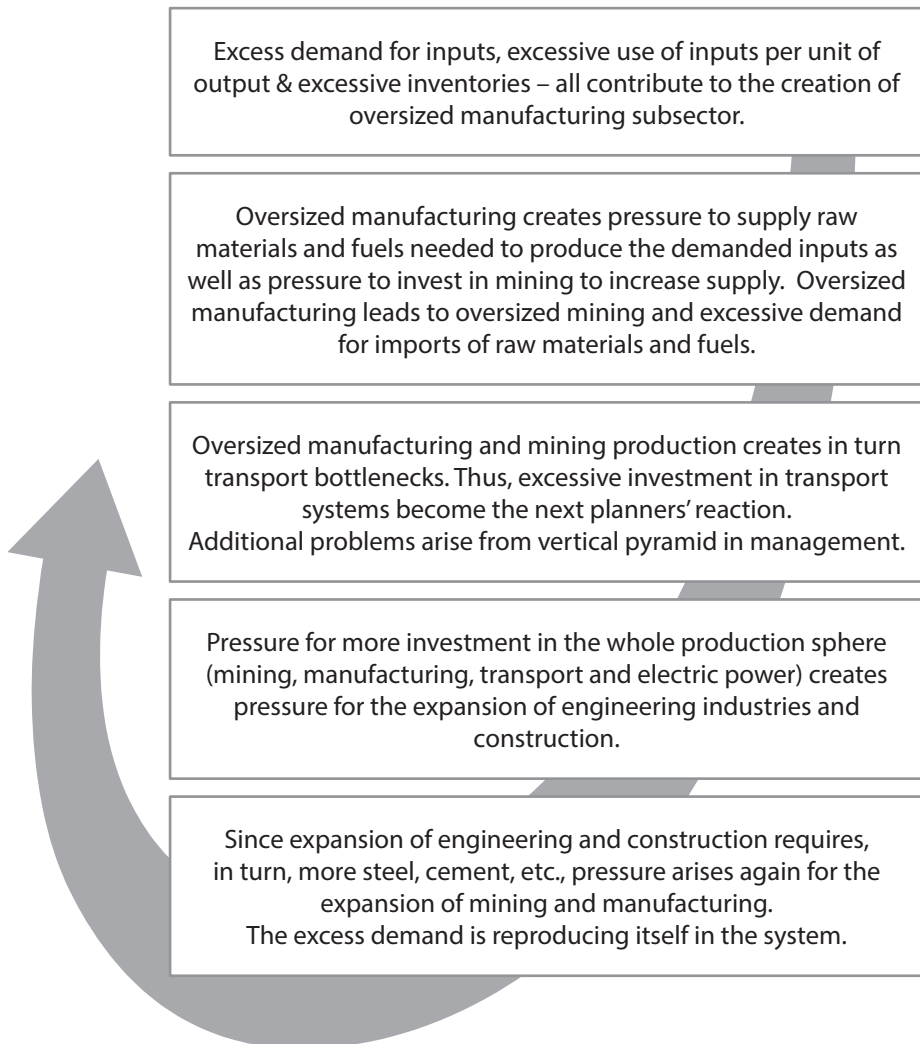
First of all, the term enterprise, meaning a separate economic unit under private ownership, is a misnomer with respect to a state unit (called here a firm or an enterprise) within the framework of centrally planned and administered economy. A state-appointed manager could not—legally—enterprise anything. He (much more rarely she in the communist system) was obliged to fulfill plan indicators; producing something else, however desirable even for a communist economy, was a crime. Even painting agricultural machinery with green paint instead of the obligatorily red one is something that Soviet managers—to be on the safe side—decided to ask for permission their superiors in the planning hierarchy. But bureaucracies work slowly and, unsurprisingly, the answer (positive)

²⁵ Martin Cave and Paul Hare, *Alternative Approaches to Economic Planning* (New York: St. Martin's Press, 1981).

came after the harvest season. The agricultural output losses were sizable, but that did not bother anybody, except the long suffering consumer.

Innovation and (good) quality were already analyzed and found to be injurious to the interest of both managers and workers. And, given the preference of central planners for quantity, they could safely be disregarded. Customization is even more antithetical to the system than innovation and good quality. After all, planners at the top and managers at the bottom generally preferred increased quantity of goods of acceptable (which, then and there, meant at best mediocre)

Figure 1.5. Self-reproducible excess demand embedded in the communist command economy and pursued industrialization strategy



quality. The idea that a product should not be standardized, but adapted to the needs of a particular customer, was beyond their comprehension.

Among the results of the change in the growth engine role was also the reversal of the trend of ever bigger production units. Smaller, more agile, private firms emerged successful in this new economic reality. The divergence of economic patterns and in consequence divergence between efficient, wealth creating growth in the capitalist market economies and increasingly inefficient, excessively resource-using, growth in command economies became bigger and bigger. It could not last forever as I stressed in the 1987 book, see Figure 1.5.²⁶ And it did not. The system soon collapsed under the weight of its own incompetence.

The “Shortcut” Years Lost in Chasing the Chimera

In the 1970s and 1980s, a joke circulated in the East European communist countries. Question: What is the definition of socialism (as incomplete communism was called there)? Answer: It is the longest and most tortuous road from capitalism to capitalism. And, indeed, it was.

The “Fatherland” of central planning and administration, Russia, is still treading that tortuous road after the incomplete systemic change. As for the Soviet times, Eric Jones asked forcefully the question in his book: “Who dare say that the present miserable standard of living among ordinary Russians has been worth acquiring at the cost of millions of dead?”²⁷ He also noted that for a long time “the Soviet economic performance was grossly exaggerated by Western sympathizers.” Table 1.3 above supplies some supporting evidence. And there is much more of it.

Already in 1963 the Polish economist, Stefan Kurowski, published a book on the historical process of economic growth, where he showed, i.e., that the industrialization of Russia, which accelerated in 1880s, if proceeded along these lines, would have achieved the same level in late 1950s that was achieved under the command economy. Thus, he answered Eric Jones’s question in the negative more than a quarter of a century before it was asked. Incidentally, in the same year, Prof. Kurowski, was stripped (retroactively!) of the freshly received post-doctoral degree (habilitation) for the book in question.²⁸

More importantly, a number of studies by Russian academics from Novosibirsk in the 1980s and early 1990s looked at Soviet economic performance.²⁹ And

²⁶ Winiecki, *Economic Prospects*.

²⁷ Jones, *The Record of Global Economic Development*, 31.

²⁸ Stefan Kurowski, *Historyczny proces wzrostu gospodarczego* [Historical Process of Economic Growth], (Warsaw: PWN Publishers, 1958).

²⁹ See, for example, Vasilii Selyunin and Grigorii Khanin, “Lukavaya Tsifra” [Distorted Numbers], *Noviy Mir*, vol. 2 (1987), 181–201; Grigorii Khanin, “Ekonomicheskiy rost: alternativnaya otsenka” [Economic Growth: An Alternative Estimate] *Kommunist*, vol. 17 (1988), 83–90; and Mark Harrison, “Soviet Economic Growth since 1928: The Alternative Statistics of G. I. Khanin,” *Europe-Asia Studies*, vol. 45 (1993), no. 1, 141–67.

they found, for example, that Soviet industry increased its output since the beginning of central planning in 1928 till 1985 in between 6 and 7 times. Not bad, but official Soviet statistics trumpeted 90 times increase in output!

The comparison of their studies of GDP growth in the 1960–85 period with their studies of industrial output growth in the whole central planning period shed light on an interesting phenomenon. Namely, it seems that the intensity of cheating varied over time. It was the largest at the Stalinist period (otherwise the 90 times increase could not have been registered by planning authorities) and in the final, declining years of Soviet Union's existence (see, again, Table 1.3).

It also adds a postscript to earlier considerations about the external perception of the progress of Soviet economy noted in 1950s and 1960s. It just happened that at that time cheating was least intensive and, consequently, realistically revised Soviet output figures actually reflected high GDP and also industrial growth. Let it be noted, however, that even these corrected figures should still be corrected further for low quality and growing technological obsolescence (see the preceding section).

Countries of the region remaining under the Soviet domination did not benefit from central planning and shortcut strategy of economic development. And the more developed they were, the larger were the losses. Hans-Jürgen Wagener compared three middle-developed East European command economies with four southwest middle-developed European capitalist economies in the period 1936–89.³⁰ The results are shown in Table 1.4. None of the three communist economies reduced the distance to the rich Western Europe (represented by Belgium in his calculations) during the communist period. By contrast, three out of four southwestern capitalist economies did.

Table 1.4. Changes in developmental distance from rich Western Europe (represented by Belgium) over the 1936–89 period (measured as a percentage of GDP per capita of each country relative to Belgium [=100])

	1936	1950	1973	1989
Greece	52	37	66	63
Ireland	65	66	59	63
Portugal	36	40	64	64
Spain	48	45	73	72
Czechoslovakia	54	66	59	54
Hungary	54	46	47	42
Poland	34	46	47	35

³⁰ Hans-Jürgen Wagener, "Rückkehr nach Europa," in *Osterweiterung und Transformationskrisen*, ed. H. G. Nutzinger (Berlin: Duncker und Humblot, 2000), 93–117.

The fact of complete failure, inseparable from central planning as an economic system and “steep ascent” as the developmental strategy, should be stressed in any evaluation of communist political and economic system. Unfortunately, few among the Western believers and sympathizers offered a *mea culpa* in their publications. One of the exceptions has been Robert Heilbroner, then professor emeritus of the New School of Social Research in New York, who a few years before the collapse of the communist system in Europe stated unequivocally that Soviet experiment may be regarded as finished. And the result of the experiment was also clear: socialism lost the inter-systemic competition with capitalism. And, indeed, there is no doubt about it.

Development Economics-based Strategy in Less-developed Countries: An Incomplete Failure

The Post-World War II International Landscape and Economic Development

Chronologically, the next challenge to the historical development pattern of the capitalist West, after the communist system considered in Chapter 1, came from choices of developmental strategy made after World War II by a large majority the so-called less-developed countries (LDCs for short). These countries appeared under a number of names. Apart from “less-developed countries,” they were also called “underdeveloped” and then “developing countries,” “Third World countries” (manifesting their difference from both the capitalist West and the communist East), and—sometimes— “countries of the South.” That last term became increasingly popular of late, in spite of some (geographic) misgivings.

By the mid-twentieth century the benign view of economic development under the liberal political and economic regime of the Western world ceased to satisfy (some) theorists and (many) policy makers. Stimuli to the search for new ideas and—later—for their adoption as policy recommendations were manifold. The story begins with the new post-World War II international landscape. The most important part of it—from the vantage point of issues considered in this chapter—was the newly achieved or forthcoming independence of former European colonies in Asia, Middle East, Africa, and the Caribbean. These new states, together with South America (independent since early nineteenth century) made what is called here “less-developed countries.”

The ruling elites in these countries faced the international environment of fierce competition between the alternative political and economic systems of Soviet-dominated East and America-led West (regardless of whether the competition had been called the “Cold War” or “peaceful coexistence” or some other propagandistic catchphrase!). It is in this framework of global political competition that elites in LDCs were considering their developmental goals.

A question to ask is what kind of elites ruled in the newly independent less developed countries? I interpret their longings for economic development as—by and large—a search for an intermediate goal. Economic development,

understood as industrialization, had been perceived by these elites primarily as a *status symbol*. Development was to hopefully lead to a mighty, developed economy. And might was what they were after in most cases. A strong state, with a mighty economy, facilitating the creation of a well-equipped military—were all seen as means of establishing a new, more balanced, relationship with their former colonial masters.

Undoubtedly, there were also within these countries' elites many genuine believers in the beneficial role of economic development as a means to alleviate, or even better, to eliminate poverty. However, regardless of priorities, an important question for both groups was what kind of guiding economic ideas to choose in order to accomplish the task.

Among the genuine believers in beneficial economic development, raising the masses from grinding poverty, was, for example, Jawaharlal Nehru, whose Congress Party ruled India during the first decades of country's independence. Nehru, educated in England, brought back to India not only a university degree, but also definite political and economic ideas, those of Fabian socialism. Given his democratic political beliefs, he distanced himself from the Soviet communist political system. Yet he rejected what he called the acquisitiveness of the capitalist market economy and opted for a state-controlled, mixed economy, with a heavy dose of central planning.

Nehru, in a paper written in mid-1940s,¹ stressed that the South must acquire the technology that made the economic success of the Western world possible. Unfortunately, he interpreted technology in the narrow sense, as production techniques that could accelerate the industrialization process.

In his attitude he did not differ much from earlier Southern rulers, e.g., those of the Ottoman Empire in the seventeenth and especially eighteenth centuries, who tried to learn about the sources of West's success. The latter also looked for technologies, primarily military technologies that helped the Western nations to repeatedly defeat the armies and navies of Ottoman emperors.²

Neither the Turks, nor Nehru (two hundred years later!) asked themselves the basic question: Why it has been the case that these technologies—for war or peace purposes—invariably appeared only in the West? Clearly, something more than military or civil technologies *per se* must have been involved.

With the benefit of hindsight, many authors, including myself, could offer sophisticated institutional answers unavailable to Nehru and his contemporaries after the World War II. However, Nehru, who had been educated in England, had then a chance to look, for example, into the century-old book of J. S. Mill, *Principles of Political Economy*. Like all classical economists, Mill had been con-

¹ See Jawaharlal Nehru, *The Discovery of India* (Oxford: Oxford University Press, 1987).

² See, for example, Bernard Lewis, *What Went Wrong? The Clash between Islam and Modernity in the Middle East* (New York: HarperCollins, 2003).

vinced that economic development would generally follow from what Adam Smith called a “system of natural liberty.”

But he stressed specifically the importance of “a better government: more complete security of property; moderate taxes, and freedom from arbitrary exaction under the name of taxes; a more permanent [...] tenure of land, securing to the cultivator as far as possible the undivided benefits of the industry [in contemporary terminology: entrepreneurship], skill and the economy [in our terminology: ability to reduce costs].”³ He also added the need to improve publicly supplied economic data. As all classical economists, Mill stressed the crucial role of economic openness. Furthermore, he expressly treated his recommendations as universal; they “apply [he wrote] more or less to all Asiatic populations and to the less civilized and industrial parts of Europe, as Russia, Turkey, Spain and Ireland.”⁴

However, Nehru, a Fabian socialist, or social-democrat in modern parlance, either did not read Mill or disregarded the (minimal) institutional requirements outlined by that classical writer. In Nehru’s view, it was the state that should direct the economy from the center, as well as decide about the allocation of scarce resources. State firms and cooperatives were to play a major role in the emerging—fundamentally collectivist—Indian economy. And, last but not least, the India’s society had to abandon its traditional modes of thought and their institutional arrangements—and (willy-nilly) adjust.

Yet it would be unjustified to be very critical of Nehru’s attitudes and revealed preferences. After all, his views and those of his contemporaries in the South, were influenced by a variety of interwar and post-World War II ideas and colored by perceptions of reality that were highly popular at the time. Let us present them in an orderly manner:

1. The Great Depression of the 1930s that afflicted the world economy was then widely seen as the most important symbol of failure of the classical, free market economic ideas. Even today many continue to evaluate the Great Depression in the same terms. And hold such view, in spite of the Nobel laureate Milton Friedman’s and other’s studies, proving the adverse public policy impact on the slide from typical recession to depression.
2. If the classical, free market-centered ideas ceased to be attractive for the many in the elites in less developed countries, an alternative, the economic successes of the Soviet collectivist system, promised—at that time—a much-desired “shortcut” in the path to economic development. True, there were few takers of the Soviet model lock, stock, and barrel. In the 1940s and 1950s the human costs of the Soviet political model were

³ J. S. Mill, *Principles of Political Economy*, Vols. 1–2 (London, 1909), 189–90.

⁴ *Ibid.*

already reasonably well-known (although only in a rather small part!). However, the (alleged) economic successes proved to be very tempting for elites in less developed countries. The Soviet Union appeared to them as a less developed country, which—thanks to its economic system of central planning—had been able to catch up with the West economically and—on that basis—militarily (both accomplishments highly appreciated by Southern elites!).

3. Not only the European East, but also the European West tempted believers in economic activism of the state to follow the highly interventionist path leading to economic development. Thus, the elites in question looked with interest at the experience of Western wartime controls imposed by the state over their privately-owned economic units. These controls were later reinforced in Europe by nationalizations of crucial sectors (called “the commanding heights” of the economy by British socialist thinkers and politicians). The spreading popularity of Keynesian macroeconomic activism increased the attractiveness of recent Western experience even more.

Again, like in the case of early Nehru’s views, one could find a lot of faulty reasoning by those who accepted such interpretations of the international environment in the middle of the twentieth century. First, the research on the Great Depression pointed to many of policy errors made by governments and central banks during the crucial period. Second, the perception of Russia as joining the great powers’ club and the group of developed economies thanks to the Soviet economic system of a command economy was grossly erroneous.

Thus, those rulers from the South, who looked longingly at Russians in Berlin since 1945, forgot that Russians more than a hundred years earlier marched even further to the West and stayed in Paris as a consequence of victory in the Napoleonic Wars. Almost unknown at the time were, unfortunately, the very high economic costs and dramatically small benefits of applying the Soviet economic model. Nobody knew in the 1940s and 1950s that, e.g., real industrial output growth amounted in 1928–85 to less than 10% of the officially proclaimed figures (see Chapter 1 above). As noted by László Csaba, “the contemporary official statistics tended to be taken at face value, which resulted in a sincere admiration for the non-capitalist alternative.”⁵

Also nonexistent was, for example, the 1963 work by a French economist of Polish extraction, Eugene Zaleski, who stressed in his book that what was produced under central planning only accidentally came close to numbers and proportions included into the plan.⁶

⁵ László Csaba, *The New Political Economy of Emerging Europe*, 2nd ed. (Budapest: Akadémiai Kiadó, 2007), 97.

⁶ Eugene Zaleski, *Planification de la croissance et fluctuations économiques en URSS* (Paris: Editions SEDES, 1963).

Third, more understandable should have been the psychological incompatibility of the continuation of wartime mobilization measures in the long peacetime period. What worked in times of emergency was never applied in democracies in times of peace, when strong mobilization demands on a society (and the call for further sacrifices) would inevitably fall on a much less fertile ground. And, without continuing sacrifices of the population, the efficiency of an economic mobilization model would decline significantly—and collapse at a certain point.

What mattered, however, were two factors. The first factor has been the already stressed political climate of approval of and even admiration for state activism dominating the post-WWII world. The second factor, so far not considered, was the resentment of the post-colonial elites *vis-à-vis* their former Western colonial masters. Although a large part of these elites obtained their education in Western Europe, they resented the colonial domination over their nations (or tribes, as the case might be). Thus, when they considered systemic choices on the eve of independence, their resentment urged them to distance themselves from the traditional Western ideas of political liberalism and economic freedom. Unfortunately, they were psychologically unable to separate Westerners as colonial rulers from Western ideas of *Rechtstaat*, liberal democracy, and capitalist market order. In consequence, the receptivity to a variety of socialist ideas as an alternative to Western liberal tradition had been augmented by the resentment.

Whence Came the Body of Thinking Called “Development Economics” And What Kind of Recommendations It Offered?

Readers may be tempted to ask a question, why *development economics* has been put in parentheses or marked with italics? The answer is simple. This is how development economists—meaning those subscribing (in broad terms) to the views formulated by early development economists—wanted to differentiate themselves. They called the body of thinking they adhered to *development economics*, in contrast with *economics of development*, which they understood to be merely the application of standard, “mainstream,” classical *cum* neoclassical, economics to the problems of economic development. Theirs was—they often stressed—a separate body of economic thinking more appropriate for solving the problems of economic development.

Thus, they considered specific institutional changes and policies (as well as broader strategies, that is coordinated policy mixes), which the highly activist state should adopt to initiate and/or accelerate country’s economic development. These policies were based on certain fundamental principles. The four pillars of *development economics* could be summarized as follows:

1. The economy should be managed from the center, and state control should supersede to an important extent the operation of price mechanism. More often than not the management should take the form of plan-

- ning. The major thrust of development economics was to justify a massive government intervention, especially in capital accumulation and allocation, via the range of direct controls. This formed the background thinking for more specific interventionist measures.
2. Forced industrialization, orchestrated by the state action, was to become the most important part of the economic development strategy, to the detriment of the spontaneous structural change, affecting intra- and inter-sectoral proportions in the national economies. Within the industrial sector, priorities were given to the rapid establishment and expansion of ever more sophisticated branches of industry, with their corollary – production of machinery and equipment.
 3. Forced accumulation of financial resources to accommodate forced industrialization was to be pursued, again, via interventionist measures. They were in a large part to substitute for more normal, spontaneous development of financial markets and voluntary savings of the population. Privately-owned financial institutions, where they were allowed to exist, were to be forced to set aside a commanded volume or percentage of expected lending for “priority,” state-sponsored investment projects.
 4. “Export pessimism” was the term synthesizing the disbelief, prevailing among development economists, in the ability of the South to substantially increase their export earnings. Pessimists concentrated on the export of commodities: agricultural products, raw materials, and fuels (not expecting any meaningful volumes of manufactured exports). Given the perceived large needs of industrialization-related imports, they advocated foreign trade controls and generally reduced interaction with the world markets.

A combination of the foregoing second and fourth pillar gave rise to the strategy called *inward-oriented (import substitution-based) industrialization*. The “forced draft” industrialization (to use another term coined by Everett Hagen) and forced separation from the world markets suggested near-autarchic expansion of industry. New as well as old industries were to operate under the protection of high tariff and non-tariff barriers.

What rationale development economists offered to justify their recommendations? In other words, what kind of reasoning underpinned the four pillars of development economics-based strategy? I am of the opinion that the cornerstone of the thinking of development economists was the disbelief in what may be called “economic principle.” To varying extents, development economists (and other left-wing intellectuals) rejected one of the fundamentals of classical economics. The principle in question says that people—as stated by the Nobel laureate John Hicks—“would act economically; when the opportunity of an advantage was presented to them, they would take it.”⁷

⁷ John Hicks, *Causality in Economics* (Oxford: Blackwell, 1979), 43.

Disbelief in individuals had been accompanied by the disbelief in, or distrust of, markets, composed as they have been of private economic agents. Both the behavior of consumers-employees and that of producers-entrepreneurs required, according to development economists, an intervention of the guiding—and corrective if needed—hand of the state.

In accordance with this view, to constrain those supposedly myopic and/or ignorant individuals, it had been necessary to establish as a countervailing and dominant power some official entity (central planning or development office, or some other governmental agency). The entity in question, composed of knowledgeable, conscientious, and compassionate officials, would be able to overcome the defects of private economic agents and compel them to act—through various interventionist measures—in such ways as to increase everybody's wellbeing (by implication, even against the will of those who were supposedly to benefit from the interventionist measures!). Poor peasants, urban traders, entrepreneurs—almost everybody came under the heading of “myopic or ignorant” economic agents. Only modernizing elites, accepting the tenets of “development economics,” were above criticism.

Already in 1943 Paul Rosenstein-Rodan wrote an article wherein he maintained that “complementarity of different industries provides the most important set of arguments in favor of a large-scale planned industrialization” and the whole industry to be created should be “treated and planned as a large firm.”⁸ The Marxian idea of the one big firm taken over by the state after the successful revolution was clearly present in Rosenstein-Rodan's thinking. So was the planning experience of the Soviet Union since 1928. Many other economists shared both the intellectual inspiration and practical recommendations of such a mode of thinking. For example, Ragnar Nurkse wrote about a balanced pattern of investment in a number of different industries, calling his version of a plan a “balanced growth.”⁹ The idea of a “big push” that was affirmed also in Rosenstein-Rodan's later writings found widespread support.

There were those who called for the developmental strategy based on “unbalanced growth.”¹⁰ Hirschman stressed that certain industries have more backward and forward linkages than other. Therefore, investing in more strongly linked industries would yield higher aggregate output. However, balanced or unbalanced, the strategy assumed state guidance and state finance. Thus, they were both branches of the same interventionist tree of development economics.

While presenting strategic choices within development economics it is worth stressing the similarity of “big push”-based strategy to the Soviet-style

⁸ Paul Rosenstein-Rodan, “Problems of Industrialization in Eastern and South-Eastern Europe,” *Economic Journal*, vol. 53 (1943), 204.

⁹ Ragnar Nurkse, *Problems of Capital Formation in Underdeveloped Countries* (Oxford: Blackwell, 1953).

¹⁰ Albert O. Hirschman, *The Strategy of Economic Development* (New Haven, CT: Yale University Press, 1958).

“steep ascent” strategy. The latter also assumed a large-scale capital investment effort, with the aim of creating in a relatively short time span a “minimal industrial complex.” The complex was to contain some heavy industry branches, so as to be able to supply domestically a substantial part of needed capital equipment. In terms of socio-economic consequences both “big push” and “steep ascent” implied major shift between consumption and accumulation in favor of the latter—and an involuntary shift at that.

The debate among theorists and practitioners about planning had usually centered on the stronger or weaker preference for Soviet/Chinese-style compulsory planning, that is, central determination of physical quantities of goods and services, or for West European-style indicative planning, with dominant indirect policy inducements for economic agents. The outcome was usually a mixture of both, but with distinctly different proportions of both components across the less developed world.

The state-centered development strategy, strengthened by some planning agency, was expected primarily to initiate or accelerate industrialization. For many in the elites industrialization, as stressed already, was *the* development strategy. And it was the strategy giving priority to domestic production of hitherto imported consumer goods and creation of heavy industries in order to extend the range of domestic production to consumer durables and, as the pinnacle, to the manufacturing of machinery and equipment. The alluring (although largely misleading) example of the former Soviet Union contributed strongly to the popularity of such priorities.

Thus, the composition of investment, and therefore of future output, clearly mattered for development economists. It is worth stressing, however, that investment composition was seen by them as almost completely malleable (that is, independent of the level of economic development). The existence of a problem in investing and, then, producing sophisticated goods, which were above LDCs’ actual level of competence has never been admitted in development economists’ debates.¹¹

The thinking behind the industrialization strategy was that in order to become mighty developed economies, less developed ones should adopt strategy of “replicating the North,”¹² that is, Western economies since Bruton used the North–South terminology. In fact, the same thinking pervaded the debates of central planners and their political masters in communist countries. In the devel-

¹¹ See, by contrast, Jan Winiecki, “Industrialization and Economic Development (On difficulties and pitfalls in the process of ‘catching up’),” Viadrina-European University, Frankfurt an der Oder, 1999, mimeo. See also Gaidar, *Anomalie*, Chapter 2. The latter, however, seemed to associate the strategy in question only with large LDCs, not noticing that an even larger number of smaller ones pursued the same strategy at a much greater cost to themselves.

¹² Henry J. Bruton, “A Reconsideration of Import Substitution,” *Journal of Economic Literature*, vol. 36 (1998), 908.

opmental strategies of both groups of countries industrialization was expected to lead to the creation of increasingly modern industrial structures and to manufacturing of the increasingly sophisticated products so far imported from the West. Another tenet of the thinking in question had been strong protection of the emerging industries (if not downright autarchy).

Industrial expansion behind protectionist barriers seemed to be the safest development strategy. Numerous export pessimists among “development economists” (see below) not only believed that LDCs had little chance to compete with producers from developed countries in the world markets, but were pessimistic of LDCs competing even in their own markets.

The inward-oriented strategy of building industrial base excluded by definition the inflow of private capital. Thus, the search for new sources of financial means, needed to raise the level of domestic savings and allocating them for development-related purposes (primarily industrialization), became one the pillars of the development strategy in most LDCs.

Domestic savings are usually generated voluntarily, at least in the capitalist market economy. Also, changes in the level of savings occur spontaneously under the impact, i.a., of the changing structure of incentives (often affected by governmental regulatory regime) and higher levels of economic development. Such savings as generated in the national economy are, then, deposited in financial institutions that, in turn, reallocate them to the most profitable uses.

However, “development economists” have seen the largest problem of LDCs in too low level of savings relative to the needs of the “forced draft” industrialization specifically and accelerated economic development in general. The elites were in a hurry and, therefore, opted for the generation of involuntary savings, in accordance with the prescriptions of interventionists of various intellectual persuasions.

Their *development economics*-oriented advisors fully agreed. For example, British economist, Nicholas Kaldor, stressing the need to establish the non-revenue-yielding services, including the physical infrastructure, did not doubt that “taxes or compulsory levies provide the most appropriate instrument for increasing savings for capital formation out of domestic sources. By reducing the volume of spending by consumers, they make it possible for the resources of the country to be devoted to building up capital assets.”¹³

An important question became the choice of methods to generate the needed (high) volume of involuntary savings. Taxation of income earned was largely seen as impractical in poor countries with weak (and corrupt) tax bureaucracy. Next, communist-style compulsory lending to government through the sale of nonnegotiable government bonds, “sold” under duress to state sector employees, a common phenomenon in the Stalinist period, was doubtful for sim-

¹³ Nicholas Kaldor, “Will Underdeveloped Countries Learn to Tax?” *Foreign Affairs*, vol. 41 (1963), no. 2.

ilar reasons. Besides, the extreme Soviet arrangements were not popular with all LDCs' leaders and elites.

Thus, among more widely acceptable options were sales' taxes, import and export taxes, and some tax-like intrusions into the private financial sector. For example, in many LDCs, the privately-owned banking sector was burdened with set-aside quotas: the obligation to allocate a certain percentage of lending volume to finance government-indicated priority projects—and finance at concessional (low) interest rates. Since an alternative for bank owners was nationalization such arrangements were seen by them as a lesser evil.

Another popular option, squeezing agricultural producers, generated many varieties of such squeeze, for example, the manipulation of prices of exportable (cash) crops. Governments either took over existing marketing boards, which historically were helping farmers in purchasing production inputs and delivering outputs to prospective buyers, or created similar units and turned them into state-owned legal monopsonies. Such a monopsony had the exclusive right to purchase from farmers a particular exportable crop at markedly lower prices than before and selling them on the world market at current (higher) prices. The differential was to be used to finance economic development.

Furthermore, the credit expansion by a state-owned development bank, or more generally by the central bank—and the resultant inflation—had always remained an option. And it was an option frequently resorted to in most countries.

At last, I arrive at the fourth pillar of “development economics,” namely export pessimism, its argumentation, and policy consequences. There is a particularly long list of eminent development economics' celebrities, who contributed in various ways to the formation of “export pessimism,” based on disbelief in economic growth-enhancing role of international trade, as far as less developed countries were concerned. The pessimistic argumentations were presented in an ever more critical manner.

Ragnar Nurkse, basing his argumentation on demand factors alone (in line with the Keynesian fashion of the times), argued in early 1950s that foreign trade cannot play the role it played in nineteenth century in the case of the U.S., Canada, Argentina, or Australia. In his opinion, demand for commodities from developing countries (especially tropical agricultural products) could not grow sufficiently rapidly to enable producers of commodities to make exports a driver of growth. Nurkse regarded income elasticity for commodities to be low (so-called “elasticity pessimism”). Therefore, he advocated what was in effect a policy of forced industrialization through import substitution in order to reduce the expected demand for imports, needed in an open growing economy.

Raul Prebisch, a policy practitioner (secretary general of Economic Commission for Latin America, ECLA, of the United Nations) and theorist, not only supported Nurkse in his writings, but went a step further. For he argued that even if LDCs had increased the volume of exports, the increased supply would

have led to deteriorating *terms-of-trade* and, consequently, would not increase the volume of export earnings.

An interesting feature of “export pessimism” was that no “development economist” envisaged the possibility—at that time just around the corner—that developing countries could be able to competitively export manufactures. In 1953 exports share of manufacturing products amounted only to 7.1%, in 1965 to 11.7%, while 5 years later, in 1970, it already amounted to more than a quarter (26.4%). Thus, over time, manufactures were to take increasingly large place in exports of more successful less developed countries.

Yet it is worth stressing that Nurkse, Prebisch, and other similarly thinking pessimists did not adopt an extreme position. They did not reject the basic idea of international trade since Adam Smith and David Ricardo, namely the gains from trade. By contrast, Gunnar Myrdal and Thomas Balogh went much further. They postulated, contrary to the classical view, that a liberal international trade and payments’ regime, is a sort of a zero-sum game, which enables the rich countries to prosper at the expense of the poor. It was, thus, an outright rejection of the basis of international economic order—the two hundred years of international trade theory.

Altogether, the message of export pessimism was clear. The only feasible option for governments of LDCs was to husband their precious (because scarce) foreign-exchange resources for use in areas “essential” for development purposes. The general message augured badly for consumer sovereignty. With the start of *development economics*-based strategy, it was development planners and their advisors, who were to decide not only about shares of accumulation and consumption, but even about individual imported products that indigenous population could or could not consume in consequence of their decisions. And it should be kept in mind that “development economists” and planners in general had their own ranking of preferences, usually different from typical urban or rural consumer.

A relevant example is offered by the contrast between a Polish socialist, Prof. Witold Kula and a future Nobel Prize winner in economics, Milton Friedman. Kula, an economic historian, was envisaging during World War II the shape of the future socialist regime in Poland. Thus, he wrote in 1941 that the state, while guiding the economy, should “decisively put a stop to the production of luxury versions of consumer goods.”¹⁴

What constituted a luxury was of course to be decided by development planners. For Kula such luxuries included, i.a., female lipstick. And, since the future socialist regime required—in Kula’s mind—also a “new socialist person,” he did not hesitate to propose augmenting the policy decision with an indoctrination campaign. Thus, various organizations were, for example, to put pressure on young boys, so that they would feel ashamed of appearing in the company of

¹⁴ See Witold Kula’s collection of articles: *Historia—Zacofanie—Rozwoj* [History—Backwardness—Development] (Warsaw: PWN Publishers, 1983), 20–1.

lipstick using girls. Witold Kula lived long enough to see the failure of his crude egalitarian dreams, but that did not prevent him from republishing decades later, without a word of reassessment, let alone regret, articles like the one quoted here.

What a difference with a column by Milton Friedman I read in *Newsweek* in 1970s, where he encouraged India to liberalize its economy: reduce the heavy interference of the state and use more incentives of the market. Significantly, Friedman also used lipstick as an example, but with the opposite message. He wrote that a poor Indian girl would have to wait a long period before she would be able to save enough to buy even the smallest apartment. But in the meantime she should be able to enjoy some small pleasures of life such as a lipstick: a typical case of “incentive consumer goods,” which raise the aspirations to consume and—consequently—to work, earn, and save. It was a lesson in the ABCs of an economy based on incentives.

Without the Benefit of Hindsight:

Some Comments on Development Economics and Pursued Strategy

Since the late 1960s development economics’ tenets and the developmental strategies pursued on their basis had been subjected to an increasing criticism. The criticism had been based mostly on the contradiction between theorizing on development and recommendations for developmental strategy and policies on the one hand and its observed effects since World War II on the other. I am going to deal with the criticisms of that sort at the close of this chapter. However, the new body of thinking should have raised a lot of questions and criticism even without the benefits of hindsight. The knowledge accumulated over two centuries, from Adam Smith time to the middle of twentieth century, offered more than enough of intellectual support for such an inquiry.

I would like to begin with Adam Smith himself who, in contrast with “development economists,” stressed already in the eighteenth century that it is ingrained in the human nature to strive to better one’s living conditions, as well as to truck and barter for that purpose. It is the original underpinning for the quoted Hicksian economic principle. Thus, the separation of individuals into two categories (knowledgeable, competent bureaucrats and their advisors and passive, myopic, and ignorant economic agents) runs counter to what has been the common wisdom of thinkers over centuries. A long series of empirical studies by Peter Bauer and others, as well as later generalizations of Bauer and Nobel Prize winner Theodore Shultz, about the behavior of poor farmers proved Adam Smith right. Thus, the denial of the uniformity of behavior in the face of similar incentives was more a facile rationalization of the interventionist urge than an empirically grounded reality.

Moving from the (alleged) failure of individuals to react to incentives to the (alleged) failure of markets, I would like to refer to the 1945 Friedrich Hayek’s article about market prices as low-cost information disseminating devices.

Consequently, there existed at least the suggestion at those times that superseding markets for commands may amount to superseding a less expensive for more expensive institutional arrangement.

Believers in development economics' prescriptions—and in central planning as well—used to point out to the allegedly ubiquitous market failures and stressed that planning would do what imperfect markets could not. However, as stressed already by Ludwig von Mises and Friedrich Hayek in the planning debate in 1930s, successful planning is dependent on unrealistic assumptions.

In the later period of development debate, the argumentation against the superiority of planning was best formulated by Deepak Lal.¹⁵ He pointed out that planning arrangements in *development economics*-based strategy depend, like all planning, on the assumptions of omniscience, omnipotence, and benevolence of the government. He was ready to accept the assumptions of omnipotence and benevolence, but not omniscience.

Even if we assume that planners receive all the information concerning the past and present, allegedly displaying an advantage in this respect over individual entrepreneurs (a belief, for example, held by Rosenstein-Rodan),¹⁶ they do not have an informational advantage with respect to the *future*. Lal stressed that all investments cope with the uncertainty of the future. All are hostages to fortune. Devoid of omniscience, imperfect planning in the real world does not have any advantage over imperfect markets. In fact, Lal points out that decentralized bets about future effects of today's investments may have an advantage over the centralized big bet of planners. Multitude of small investments may be sounder strategy than putting all eggs in one (centrally planned) basket.

Worth adding to the above is yet another aspect of doubt, this time concerning omnipotence. Omnipotence, for example under the command economy regime, may be understood as the ability of planners (and their political masters from the politbureau) to prevent people from acting in ways undermining the implementation of planning goals. Yet from the experience of Soviet Union and other communist regimes we know very well that cheating one's superiors had been an everyday occurrence (see above, Chapter 1). And, let me add, in spite of very heavy penalties. Even in 1980s, the relatively least oppressive years of the (then fast declining) Soviet system, about 6,000 managers of state firms languished in Soviet prisons, largely for doctoring plan reports. Undoubtedly, a majority of the remaining managers were doing the same; what saved them from prison was the informational asymmetry facing higher levels of planning hierarchy that allowed managers to thrive on doctored reports.

¹⁵ Deepak Lal, *The Poverty of "Development Economics,"* 2nd ed. (London: Institute of Economic Affairs, 1997).

¹⁶ Paul Rosenstein-Rodan, "Notes on a Theory of Big Push," in *Economic Development for Latin America*, ed. H. E. Ellis (New York: St. Martin's Press, 1961), 57–66.

Yet another problem associated with numbers available to planners, however, takes us back to omniscience. Planners may be affected adversely by statistical aggregation. For example, demand for capital, while planning multiple investments, becomes at a certain point a one aggregated number. John Hicks stated that the assumption of the homogeneity of capital was a disaster: "Like other metaphysical entities, it is a boat that is loose from its moorings [...]. If there is just one homogenous 'capital' [...] there can be no problems of malinvestment."¹⁷

But in both communist countries and in LDCs pursuing accelerated development strategy along the lines of *development economics*, malinvestment was *endemic*. In fact, the post-communist transition may be called a process of moving from maldevelopment to development, shedding in the process not only distortionary institutions of the command economy, but also a large number of specific firms and plants—unfortunate products of malinvestment.

Also in LDCs the malinvestment, emerging in the process of planning and implementing simultaneously a large number of new plants, new firms, and new industries—as suggested in writings of Rosenstein-Rodan, Nurkse, Leibenstein, Gerschenkron, Myrdal and many others—was to be expected. And not only because of the need to cope with unknown future technologies, future demand changes, etc., but often because of the error of aggregation of allegedly homogenous capital. In both groups of countries planners were too far away from a given industry and its problems, from changing factor proportions, changing material inputs and from other industry-specific issues, undiscoverable by those using aggregate numbers, input-output tables and other props, composed years earlier and made irrelevant or even misleading by real-life developments affecting every industry. A sizable part of undertaken investment decisions must inevitably have been erroneous.

And yet development economists and policy makers in LDCs strongly believed that it is the state, which should manage the economic development from the center. They pushed strongly for a "big push" in an effort to break what many of the former called *the vicious circle*. Authors such as Nurkse understood the vicious circle as a situation in which low incomes led to low savings, low savings reduced sharply possibilities to invest, and low investments led to stagnant economy. Similar terms cropped up in the debate, like poverty trap, or more scientifically sounding low-level equilibrium trap.

The concept in question had, frankly, been quixotic, although very few economists originally criticized it along the lines of Peter (later Lord) Bauer. Bauer repeatedly rejected the concept on logical grounds.¹⁸ On one occasion he wrote tersely that "if the notion of the vicious circle were valid, mankind would

¹⁷ Hicks, *Capital and Growth*, 34–5.

¹⁸ See, i.a., Peter Bauer and Basil Yamey, *The Economics of Underdeveloped Countries* (Chicago, IL: University of Chicago Press, 1957); Peter Bauer, *Dissent on Development* (Cambridge, MA: Harvard University Press, 1972); and Peter Bauer, *Reality and Rhetoric* (Cambridge, MA: Harvard University Press, 1984).

still be in the stone age at best.”¹⁹ After all, if the circle had really been so vicious, no country would have become highly developed, like the West! All had started at one point or another as poor, underdeveloped entities.

However quixotic, the concept received world wide attention and (intellectual and political) support. Subsequent authors embellished the simple concept with other discovered vicious circles. Poor countries could not rise their level of savings, but even if they (somehow) succeeded in the effort, they would not be able to invest more because another tenet of development economics stressed the inability to increase export earnings needed to import investment goods not produced domestically (see, *export pessimism*). A number of so-called *two-gap models* emerged as a result (the most often quoted was that by H. B. Chenery and A. M. Strout, 1966).

Thus, since poor countries were trapped in the vicious circle, the assistance had to come from outside. New, post-WWII financial institutions, financed largely by Western donors, were to come to the rescue of “trapped” countries in the form of financial aid (coupled with a lot of expert advice). The whole aid-for-development community emerged as a result. On the one hand it based its activities on certain relationship between investment and GDP, such as the most popular Harrod–Domar model that became a foundation for calculating planned economic growth rate. On the other, the emergence of the aid opportunities added a second leg to these growth calculations.

Thus, if a development plan of a given LDC assumed an “ambitious” economic growth target, that is the one for which internally available savings were too small, the World Bank or some regional international development bank was expected to find the financial resources to fill the gap.

The typical procedure emerged. Two-step calculations first established the desired economic growth rate and, next, estimated the level of foreign aid needed to support the planned investment level, which—according to both domestic and international planners—was necessary to achieve the planned GDP growth rate. The criticism of the above based on institutional considerations and general logic does not need the benefit of hindsight (i.e., references to future aid failures). It is enough to ask a “development economist” a question why other countries in various periods also failed to initiate the process of economic development. For example, why large empires of the past that squeezed enough resources from their subjects failed to take the path of economic development? So-called *intensive growth*, that is GDP per capita growing in a lasting manner, began in the West, first, more slowly and later, since the eighteenth century, more rapidly. Thus, the answers should concentrate on the different structure of incentives in the West relative to rest. The idea that quantities alone (of aid, of investment, etc.) are sufficient to shift the economy onto a higher growth path should be seen as dubious, at best. But criticism of that sort was nearly absent from development debates at the time.

¹⁹ Peter Bauer, “The Disregard of Reality,” *The CATO Journal*, vol. 7 (1987), no. 1, 31.

An article by S. Herbert Frankel, in the *Quarterly Journal of Economics* in August 1952, was an outstanding exception. The said author stressed, “Development depends not on the abstract national goals of, and the more or less enforced decisions by, a cadre of planners, but on the piecemeal adaptation of individuals to goals, which emerge but slowly and become clearer only as those individuals work with the means at their disposal and as they themselves became aware in the process of doing of what can and should be done.”²⁰ Frankel pointed in the right direction—the role of incentives on the market, where decentralized economic agents operate.

Exceptions notwithstanding, the enthusiasm and interest intermingled in the fast expansion of the aid “industry.” It expanded not only on multilateral, but also bilateral basis. Western countries, with the US in the lead, had dual interest in foreign aid expansion—moral and strategic. Helping poor countries to grow satisfied the moral urge to see the destitute people rising from poverty.

This noble concern intermingled with a *realpolitik* one. I mentioned earlier in this chapter the sharp competition between Soviets and the West after World War II. It spilled over to the South, and Western politicians were concerned about the future political-economic path of less developed countries. They imagined that foreign aid could help these countries to choose liberal democracy and a capitalist market economy. I say “imagined,” because they clearly chose wrong instruments for the attainment of the goals in question. Development planning, dominant state sector’s investments in industry, forced savings, and the strongly controlled relations with the world markets were not the best means to become a fully-fledged capitalist market economy. And, without the private property of capitalist market, liberal democracy would not survive for long.

From Problems of Economic Growth to Growth of Economic Problems: Inward Orientation in Practice

The starry-eyed beginnings of the *development economics*-based strategies of inward orientation brought about a lot of excitement and hopes for better future—and better future achieved in a hurry by impatient modernizing elites. The first president of independent Ghana, Kwame Nkrumah—one of those impatient leaders—declared in 1957 that the socialist transformation (Nkrumah was a devout believer in collectivist solutions) must be very fast “to achieve in a decade what it took others a century.”²¹ The economic dreamland was to be achieved, unsurprisingly, by rapid industrialization.

²⁰ Quoted in William Easterly (ed.), *Reinventing Foreign Aid* (Cambridge, MA: MIT Press, 2008), 14.

²¹ Kwame Nkrumah, *Ghana: An Autobiography of Kwame Nkrumah* (Panaf Books, 2002), quoted in George B. N. Ayittey, “Economic Atrophy in Black Africa,” *The CATO Journal*, vol. 7 (1987), no. 1, 203.

The developmental prospects of the country looked quite good at the time. Ghana was blessed with the reasonably good administration and the judicial system, both inherited from the British, as well as the best education system in Africa. In economic terms, it was the largest exporter of cocoa in the world. And, although it was not appreciated at the time, Ghana had already experienced intensive growth (i.e., lasting GDP per capita growth) since the late nineteenth century.²²

However, it was blighted by the heavy flow of *development economics*' celebrities who descended upon the newly independent country with their ideas of how to implement the dreamed up, strictly regulated shortcut to economic maturity. The general concept was in line with the tenets of import substitution-based industrialization. High tariff walls were erected to protect the (nascent and emerging) industries and save precious foreign exchange by cutting imports of previously imported goods. Another pillar was the rapid creation of many state enterprises, in line with Nkrumah's socialist ideal of "the complete ownership of the economy by the state."²³

The most impressive project was to develop large scale, integrated aluminum industry complex, backed up by the cheap electricity generated by a large hydroelectric dam to be built on the Volta River. The project envisaged also a railway line. With a large flow of foreign aid the dam was, indeed, built in a few years by Western firms. So was a large aluminum smelter. Western advisers expected the Volta river project to be able to accelerate GDP growth to an annual rate of 7%.²⁴

The reality was, as in many later cases of inward orientation strategies, much more modest, to say the least. The integrated aluminum complex turned out to be a pipe dream. Bauxite mines were not built because there was not enough bauxite. Consequently, an alumina refinery was not built because there was nothing to refine. The smelter was producing some aluminum from imported alumina, thanks to the government-subsidized electricity from the dam. Other associated ventures of the Volta River project failed to appear. The railway was not built. The large artificial lake that was to become the area, where large fishing industry was to develop, turned out to be a failure. Even the use of the lake for a water transportation system linking Northern and Southern part of the country was not implemented.

As Easterly, a foreign aid veteran and later its incisive critic, stated sadly that even with such failures, the Volta River project was still the most successful investment project in Ghana's early history. For the industrial expansion through the establishment of various state enterprises was an even greater failure. As

²² Lloyd G. Reynolds, "Government and Economic Growth," in *From Classical Economics to Development Economics*, ed. Gerald M. Meier (New York: St. Martin's Press, 1994), 227.

²³ Aiyithey, "Economic Atrophy," 203.

²⁴ William Easterly, *The Elusive Quest for Growth* (Cambridge, MA: MIT Press, 2002), 26–8.

stressed by other sources, state firms were hopelessly inefficient. Most inputs had to be imported (in 1968 the ratio was 74%), very low capacity utilization was a norm. The result was that locally produced substitutes of earlier imported products were often more costly than eliminated imports. So, it should not be surprising that the governmental report estimated that at the end of 1966 capacity utilization in manufacturing was only 25% of the single shift capacity!

However, the major adverse impact upon the living standards of the majority of Ghanaians came not from chaotic import substitution-based industrialization, but from Nkrumah's and his successors' policy toward agriculture. The most damage came in the first decade of independence from Nkrumah's collectivistic urge. He decided upon rapid Soviet-style agricultural revolution: state farms were established, workers' brigades manned these farms, with the support of Young Farmers' League as the vanguard of mechanized agriculture. By 1965, 105 state farms were created, employing some 30,000 workers. A Food Marketing Board was established to set maximum prices for all foodstuffs. So, the recipe for disaster was made. After 5 years—and already after the ouster of Nkrumah in 1966 in a military coup—state farms recorded drastically lower productivity than private farmers: output per acre was more than 4 times lower, while output per worker was more than 5 times lower.²⁵

Maybe, even worse was the treatment of the farmers producing cocoa, Ghana's major cash crop. The typical idea of development economists and politicians following their favored strategy was to intercept a part of the cash crop farmers' income through the establishment of a compulsory state monopsony. Prices paid to farmers were reduced and the differential between monopsonist's price and world market price was pocketed by the state to finance developmental strategy in general and industrialization in particular.

The net effect of the foregoing price manipulation was the discouragement of cocoa farmers to produce. They saw their income shrinking from decade to decade (for post-Nkrumah governments pursued the same strategy *vis-à-vis* cocoa farmers). In consequence, farmers gradually reduced investment and finally many of them shifted to traditional, subsistence agriculture to feed their families. As pointed out by Ann Krueger, with a shrinkage of cocoa output by two thirds, Ghana lost its export leadership.²⁶ This should not come as a surprise if one learns that in mid-1980s Ghanaian farmers received in real terms about 10% of the price they received in late 1950s, with no large changes in the world price of cocoa taking place in the meantime! Overall, the first 30 years of independence brought about a continuous decline in living standards, combined with periodic bouts of malnutrition.

²⁵ For both industry and agriculture statistics, see Ayittey, "Economic Atrophy," 204–6.

²⁶ Anne O. Krueger, *Economic Policy Reform in Developing Countries* (Cambridge, MA: Blackwell, 1992).

Not all outcomes of inward orientation strategy were that bad. The level of policy excesses in Ghana was probably much above the average. Besides, the import substitution-based industrialization and, overall, the inward-oriented development strategy should be differently evaluated with respect to different stages of inward orientation in each country. In the literature on the subject many analysts differentiated between the easy and more difficult, later stage of import substitution. Why and how it worked, is best explained by the recourse to two concepts: the spontaneous evolution of industrial output structure and the so-called *factor reversal*.

The former concept points to the association of a particular industrial structure with the achieved level of economic development. I follow here my explanations used in an earlier study of communist command economies.²⁷ Thus, the historical, spontaneous pattern of industrialization would best be outlined as follows.

At a low level of development, with industrialization in its infancy, dominant branches would be those industries doing the primary processing of agricultural, forest, and mineral commodities. It means food, leather and leather products, textiles, wood and wood products, and the simplest non-metallic mineral products (bricks, tiles, etc.). Unsophisticated technology, low skills, and production unrelated to scale economies would combine to add little value to that of processed commodities.

As industrialization proceeded—at higher levels of GDP per capita—, other industries would become more important. At, say, a lower-middle level of development, the clothing, footwear, pulp and paper, rubber, petroleum and coal products, as well as metal products would have a larger share in the output structure. In many cases new industries would be an outgrowth of those developed earlier: clothing would be the obvious extension of textiles, footwear of leather and products, pottery and china of non-metallic mineral products. The supply side, factor proportions, in these later industries would not differ much from those most suitable for the earliest industries.

Usually (an exception is made for very large countries) industries like steel, cement, and basic chemicals would come later, when countries would reach a middle level of development. Also, as a rule, the heavy industries would come later than the light ones. Here, factor proportions would be changing in favor of a markedly greater capital intensity and to a smaller extent skilled labor-intensity. It would be a sharp change in comparison with the earlier noted supply side pattern.

Finally, at the high level of industrialization, machinery and equipment, as well as chemicals, would expand most rapidly. Within the former, production of consumer durable goods would precede that of investment goods. Machinery

²⁷ See, Winiecki, *The Distorted World*, Chapter 4; and the literature quoted therein.

and equipment would become the largest industry exceeding the share of food industry. Further changes within the output structure would take place later. All the sub-branches of machinery and equipment industry and chemicals, as well as new additions (for example, data processing and biotechnology branches of manufacturing) would be evolving within the declining share of manufacturing in GDP and employment. On the supply side, the shift would be most marked in the direction of greater capital intensity and even more—human capital intensity.

The second concept, that of factor reversal, has emerged in international trade theory and stresses the accumulation of production factors and their changing proportions over time. It links these changes with the production and later also export structure. Thus, as economic development progresses and GDP per capita increases, scarce production factors accumulate:

- Increasing GDP per capita means that, as the economy grows and an ever larger range of goods is produced, capital tends to accumulate.
- The same applies to factor human capital. Investments in education and training tend to raise the level of human capital—and accordingly the share of skilled labor in employment.

As economic development and schooling level progresses and scarce factors accumulate, the so far most abundant factor: unskilled (and semi-skilled) labor become scarcer. At a certain point in the development process factor reversal takes place. The economy shifts from an (unskilled) labor abundant to a capital abundant one. At a still higher level of development the next shift takes place—to a human capital abundant economy. Let me point out, though, that a fuller presentation of factor reversal should include also associated structural changes, beyond agriculture and industry, as well as institutional changes enabling factor reversal, for example a more developed education and research institutional set-up, as well as more sophisticated financial markets.

There are obvious consequences to factor reversal. Production structure changes along the lines of the first concept of spontaneous evolution of industrial (most importantly, manufacturing) structure. As the competence of producers in new industries increases, entrepreneurs begin to look beyond the domestic market and start exporting. With a lag, once manufacturing production structure changes, export structure changes as well.

Now, armed with the foregoing concepts, it is much easier to explain industrialization outcomes under the inward orientation strategy based on import substitution. As stressed, i.e., by Béla Balassa, at the earlier stages of structural evolution there is not much need to strongly protect the economy against imported goods. What the economy registers is an emergence and expansion of the production of non-durable consumer goods such as clothing,

shoes, and some household goods that, according to Balassa, suit the conditions of less developed countries. It means that they are produced with the intensive use of the still abundant unskilled labor. Furthermore, output increases fast because it replaces both similar products supplied by domestic artisans and/or by imports.²⁸

However, as countries move to the second stage of import substitution (IS for short), economic problems begin to multiply. To maintain a high industrial output growth rate countries should either start exporting or to continue with the second stage of import substitution in a highly protected economy. Since in most cases successful exports of manufactures had been seen as next to impossible, strategy required a shift to the expansion of industries producing intermediate goods. Please note that “export pessimism” was an assumption of *development economics*. It was not expected under the spontaneous economic development and attendant structural change. Exports of light industries’ products were prevented from taking place by the import substitution-based strategy. With light industries starved of capital that was overwhelmingly allocated to “priority” heavy industries, light industries in economies pursuing an inward oriented strategies were *made to fail*. “Export pessimism” with respect to manufactured exports was the outcome of the strategy itself, not of the feature of the low level of economic development.

Normal pattern of spontaneous structural change, combined with the accompanying factor reversal process, should result in rapid industrial output growth and, later, in export growth. Yet, the much desired shortcut, promised by the inward orientation, means that production of more sophisticated manufacturing products was usually undertaken at a too early level of economic development. The factor accumulation, as well as institutional changes, had been too limited to be able to cope efficiently with the needs of newly established capital intensive, often also scale economy-based industries. Production of these goods was increasing slowly and at a high cost.

One of the reasons was that they needed a lot of inputs not produced domestically. Already some early empirical studies showed that the imports/GDP ratio did not decline rapidly, as it should, according to the tenets of *development economics*, or did not decline at all, due to the rapid increase of imported intermediate inputs (see Table 2.1). Interestingly, the same pattern had been reported for communist command economies.²⁹

²⁸ Béla Balassa, “The Process of Industrial Development and Alternative Development Strategies,” *Essays in International Finance*, vol. 41. Princeton: Princeton University Press, 1980.

²⁹ See Winiecki, *The Distorted World*, Chapter 5.

Table 2.1. Imports/GDP ratio in selected LDCs in the 1950–66 period
(in % of GDP)³⁰

Country	1950–52	1957–59	1964–66
Argentina	9	11	7
Brazil	12	10	8
Mexico	12	11	8
India	8	7	7
Pakistan	8	7	10
Philippines	14	13	19
Taiwan	13 <i>a</i>	14	19

Note: *a*—1951–53.

Thus, the implementation of the shortcut (rapid catching-up) idea under the banner of import substitution multiplied the problems. The culprit had been the regulatory regime, first of all with respect foreign trade and investment. According to an excellent summary by Anne Krueger, output slowdown after a relatively early import substitution was, first of all, an effect of increasing restrictiveness of the international trade and payment regime.³¹ To use a term I often apply, a kind of Laffer Curve of regulation began to operate increasingly strongly (see Figure 2.1). The greater the extent and intensity of regulation, the smaller the ability of the economy to create wealth.

Coming back to the regulations in question and their specific effects, while exports of traditional non-manufacturing products declined and exports of manufactures was not undertaken under the influence of “export pessimism,” imports tended to accelerate. For although imports of consumer non-durable and durable goods had been more or less severely reduced, as required by the strategy, domestic production of these goods required—as stressed already—a wide range of imported materials, parts and components.³²

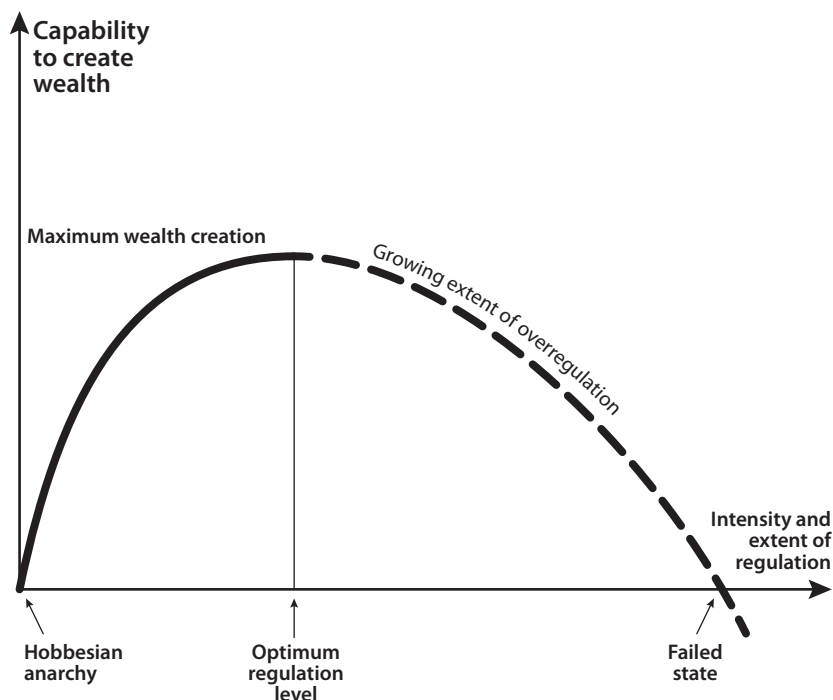
The operation of these industries was, then, dependent on the availability of foreign exchange. A paradoxical outcome of rapid “shortcut” industrialization was, then, an increase of the impact of foreign exchange constraint on domestic industrial output and the satisfaction of consumer needs. During an earlier era of imports of consumer goods, periodic shortages of foreign exchange weak-

³⁰ Source: Ian D. Little, Tibor Scitovsky, and Maurice Scott, *Industry and Trade in Some Developing Countries* (Paris: OECD, 1970), 53.

³¹ Anne O. Krueger, *Trade and Employment in Developing Countries. Vol. 3: Synthesis and Conclusions* (Chicago, IL: University of Chicago Press, 1983), 47–51.

³² Carlos Diaz-Alejandro, “On the Import-intensity of Import Substitution,” *Kyklos*, vol. 18 (1965), no. 3.

Figure 2.1. Regulatory Laffer's Curve



ened domestic currencies and in consequence raised the cost of imports. Some importables became in consequence (temporarily) out of reach of domestic consumers. After a shift to import substitution, balance-of-payment crises and resultant policy interventions caused that not only consumer needs were left unsatisfied, but also aggregate output of industry declined periodically due to shortages of imported inputs, aggravating unemployment problems.

Things looked even worse with the continued import substitution reaching a second stage. For intermediate, capital-intensive goods required much larger foreign input to their production and maintenance of costly equipment. Moreover, it is these more sophisticated, capital-intensive industries that generated additional problems not only of output volume, but also of output costs. The existence of scale economies meant in small countries (and most LDCs are small!) that output in general, not only under compulsory output cuts during foreign exchange squeezes, was much below the minimum efficient scale, and therefore very costly. Such high costs, measured in domestic prices, artificially boosted the share of manufacturing, creating an illusion of industrial might. The phenomenon was noted already in late 1960s, as shown in Table 2.2.

Table 2.2. Contribution of manufacturing to GDP in selected LDCs measured in domestic and international prices (DP and IP), in %³³

Country	Year	Manufacturing share
Argentina (DP)	1958	31.3
Argentina (IP)		22.5
Brazil (DP)	1966	27.9
Brazil (IP)		21.3
Mexico (DP)	1960	19.0
Mexico (IP)		17.2
Pakistan (DP)	1963/64	7.0
Pakistan (IP)		0.4
Philippines (DP)	1965	19.0
Philippines (IP)		15.2
Taiwan (DP)	1965	18.7
Taiwan (IP)		17.0

It is worth noting that the same type of distortions was generated, albeit on a larger scale, under central planning (see Figure 1.3 in Chapter 1). In fact, a number of similar distortions had been registered in both command economies and in LDCs pursuing import-substitution based inward-oriented development strategy. Invariably on such occasions the extent of distortions and the scale of negative economic effects were smaller in the LDCs in question. Such a pattern should not be surprising. After all the command economy had been a more extreme version of the same collectivistic governance role of the state in the economy.

Furthermore, both with respect to labor-intensive and capital-intensive industries, the productivity growth was slow and often nonexistent. Apart from problems enumerated above, a very strong negative impact on productivity growth came in these economies from the weak or nonexistent *competition*. The IS idea was that the country substitutes imports with domestic production. But the planners' idea was at the same time for firms to produce only as much as it was needed to conserve the scarce foreign exchange (most investment goods had to be imported).

Next, much of IS goods—of both easy or more difficult stage—required imported inputs. Thus the allocation of foreign exchange was usually based on the last year or last few years pattern. It meant, however, that better, more productive firms could not expand and, worse, low productivity and low output

³³ Source: Ian D. Little, Tibor Scitovsky, and Maurice Scott, *Industry and Trade in Some Developing Countries* (Paris: OECD, 1970), 73.

quality firms were not forced to exit. An empirical study of the 40 years of India's industry in the 1950–89 period revealed that aggregate efficiency declined over the period in question by 0.34% annually.³⁴

India was probably the worst case of institutional rigidity. Jagdish Bhagwati wrote the following about the 1947–91 period: "Few outside India can appreciate in full measure the extent and nature of India's control until recently. The Indian planners and bureaucrats sought to regulate both domestic entry and export competition, to eliminate product diversification beyond what was licensed, to penalize unauthorized expansion of capacity, to allocate and prevent the reallocation of imported inputs, and indeed define [...] virtually all aspects of investment and production through a maze of kafkaesque controls."³⁵ The problem of LDCs was, unfortunately, that many other countries were not very far behind India with respect to the "kafkaesque" planning and control.

My explanation of the foregoing linkages between the *development economics*-driven strategy and pursued policies should not end at this point. It has been explained why such a strategy had been deficient in the first place. I now need to explain why the strategy generated increasingly bad results over time. Here, a reference to Ann Krueger's Princeton lectures is highly enlightening.³⁶

Referring to macroeconomic stability, she underlines that, e.g., budget deficit of some size in the first year would result in lower inflation than in the tenth year in a row. For people had by then adjusted their behavior and reduced their (real) cash balances they were ready to hold. The same applied to, say, import licensing. The damage done to the efficiency of production and trade in the first year would be much lower because the market behavior of the preceding year would serve as a guide for the allocation of licenses during the implementation of such strategy. However, accumulating distortions of various kinds would impact upon the performance of firms and—in the aggregate—of the whole industry to a much greater extent in the tenth year.

However, even allowing for the effects of gradually increasing distortions, the outcomes of the strategy should not have been as bad as they often were in reality. What had been missing in most of the economic literature on the development economics-driven strategy was the interaction between economics and politics, as well as between these two areas of activity and social mores. One of the positive exceptions to that neglect was Richard Pomfret.³⁷

³⁴ Sumit K. Majumdar, "Government Policies and Industrial Performance: An Institutional Analysis of the Indian Experience," *Journal of Institutional and Theoretical Economics*, vol. 152 (1996), no. 2, 395.

³⁵ Jagdish Bhagwati, *India in Transition: Freeing the Economy* (Oxford: Oxford University Press, 1993), 49.

³⁶ Krueger, *Economic Policy Reform*, 12ff.

³⁷ Richard Pomfret, *Diverse Paths of Economic Development* (New York: Harvester Wheatsheaf, 1992), 22–3.

He pointed in his book to the issue raised also by me in the first section of this chapter, namely to the “predilections of modernizing elites.” With their preference for breaking out of the (alleged) vicious circle they were in a hurry to achieve the ultimate goal. Reliance on incentives and the decentralized arrangements of the market was regarded by them as too slow and uncertain, so they most often opted for centralized policy-making. Pomfret rightly treats that as the invitation to a one-party rule and autocratic, repressive political regime. And such regimes became more concerned with retaining political power and giving priority to their own interests rather than to economic wellbeing of the general public.

Let me return at this point to expectations concerning the rulers in LDCs, who were expected to play the role of Plato’s guardians, characterized by omniscience, omnipotence and benevolence (see “Without the Benefit of Hindsight: Some Comments on Development Economics and Pursued Strategy” above). Deepak Lal, quoted in that same subchapter, questioned the omniscience of rulers, while my own comments there questioned the omnipotence with respect to both communist totalitarianism and less developed countries’ authoritarianism. But Pomfret in 1991, rightly, questioned rulers’ benevolence—at least with respect to the majority of them.

The discovery of the problem in early 1990s is surprising to some extent as the issue of political despotism and attendant corruption had been signaled much earlier in the development-related literature. British political sociologist of Polish extraction, Stanislaw Andreski, in his book called pointedly *The African Predicament: A Study in the Pathology of Modernization*, wrote extensively about both phenomena.³⁸ In his words, instead of democracy we saw dictatorship or strife and despite the implantation of new industries (the result of *development economics*-based strategy—J.W.) we saw spreading poverty. And commented that “(a) large part of economic difficulties [...] stems from the tendency to jump the stages: to concentrate on grandiose schemes and to neglect more prosaic but immediately useful investments [...] the manufacture of spades and hammers and wheelbarrows.”³⁹

Prof. Andreski not only easily saw through the strategic errors of “development economists” and their political apprentices, but also noted the pathological institutional environment for economic development. This was done both in *The African Predicament* and in an earlier one.⁴⁰

Although Prof. Andreski’s political colorings were staunchly social-democratic, his criticism of the hostile institutional framework for economic initiative, innovation and entrepreneurship could come as well from neo-liberal public

³⁸ Stanislaw Andreski, *The African Predicament: A Study in the Pathology of Modernization* (London: Michael Joseph, 1968).

³⁹ *Ibid.*, 36.

⁴⁰ Stanislaw Andreski, *Parasitism and Subversion: The Case of Latin America* (London: Weidenfeld and Nicolson, 1960).

choice, logic of collective action, property rights and other strands of economic thought, developing in 1970s and 1980s. Thus, he stressed that the expansion of government controls shifted attention of business firm owners from taking care of production and marketing to competing for the goodwill of bureaucrats. He reminded readers that economic progress requires law and order. "Planning, saving, and investment become unprofitable if nothing is secure."⁴¹

Parasitism, that is obtaining a larger share of wealth than the person's contribution to its creation, he wrote, became the norm both in politics and in the economy, destroying the link between effort and reward. It was Andreski who invented for that type of an institution a term *kleptocratic state*. A kleptocratic state is a sub-category of Douglass North's *predatory state*. North later changed his term to the "natural state,"⁴² and characterized it as a "limited access order."⁴³ However, for the purpose of this book the predatory state is a preferable term in my opinion.

Thus, corruption—understood as a use of public office for private enrichment—became endemic in many a less developed country, benefiting large swathes of ruling elites, as well as their relatives and their underlings. It offers also the best answer to the question: why so many obviously harmful policies within the framework of inward orientation strategy continued to exist even if it was well documented that they had been a resounding failure.

Two examples: those of agricultural marketing boards and state-owned enterprises, taken from Krueger's *Economic Policy Reform*,⁴⁴ offer a glimpse into the world of economic beneficiaries of political corruption. I already mentioned agricultural marketing boards for cash crops (cocoa, coffee, tea, groundnuts, sisal, jute, etc.), turned into monopsonists, compulsorily buying crops from farmers at below market prices and exporting them at higher market prices. Such arrangement, harmful for farmers, whose ability to invest and expand was reduced, offered at least a prospect of contribution to financing the developmental strategy. Over time, however, the surplus to be transferred to state treasury began to shrink, while simultaneously prices offered to farmers were repeatedly reduced (see above for the case of Ghana). Why? Politicians in LDCs soon realized that such institutions like agricultural marketing boards (AMBs for short) are a useful lever for both political support and personal enrichment. The latter opportunities were also noted by bureaucrats running the agencies.

So, AMBs became a convenient place of employment for those whose favors were needed by politicians and bureaucrats. A highly attractive place because it offered extra opportunities to combine the income from the job with

⁴¹ Ibid., 31.

⁴² Douglass C. North, Joseph Wallis, and Barry R. Weingast, "The Natural State: The Political Economy of Non-Development," March 2005, mimeo.

⁴³ Douglass C. North, John Joseph Wallis, Steven B. Webb, and Barry R. Weingast, "Limited Access Orders: A New Approach to the Problems of Development and Violence," Policy Research Working Paper No. 4359, The World Bank Independent Evaluation Group.

⁴⁴ Krueger, *Economic Policy Reform*, 23ff.

that from corruption (e.g., from dishonest grading of purchased crops: paying farmers for a lower grade crop, while registering in the books a higher grade—and pocketing the difference). Besides, AMBs—loaded with largely incompetent people—became decreasingly efficient. Lower standards of performance resulted in storage facilities not being available when needed, purchasing agents not arriving on time to collect harvested produce, badly functioning AMBs' transport system, etc. In an apparent paradox, however, as AMBs became decreasingly useful in gathering financial resources for the state, the political support for their continuation increased. Prof. Krueger concludes that “in the process, reasonably strong vested interests [in corruption] had been developed which would make any effort to dismantle the boards and to trim their costs politically very difficult.”⁴⁵

Another case was—and in some countries still is—the state-owned enterprises. In accordance with the *development economics* ideology, the state was not only to become the governing center of the economy, but important parts of the economy were to become state-owned. State-owned enterprises (SOEs for short) multiplied through both nationalization and establishment of new firms from the scratch. In the case of nationalized foreign-owned private mining and (less often) manufacturing firms, they were taken over under the convenient slogan that mineral resources should belong to the country, where they were located and all profits, not only those from taxes, should belong to the people. In other cases some convenient explanation had been invented, whenever needed.

But over time the same process described in the case of AMBs had been taking place in state-owned firms. Instead of increasing the flow of revenues to state treasuries SOEs registered the reverse process: less and less revenues and, after reaching a turning point, growing deficits.

In Prof. Krueger's *Economic Policy Reform* book one finds examples of Sri Lanka's mining monopolies shifting from revenues to subsidies to the tune of 5% GDP, Egyptian SOEs generating losses over almost a decade between 5% GDP and later 3.5% GDP. She also quotes there her joint study with Baran Tuncer, revealing that Turkish SOEs used 3 times as much capital and 4 times as much labor per unit of output than private enterprises! Unsurprisingly, by 1980, the aggregate deficit of all SOEs was equal to staggering 8% GDP! There is no doubt about the fact that corruption markedly amplified the already adverse output effects of the strategy itself.

Development Economics-based Strategy: *Was Inward Orientation Worth the Bother?*

Strong believers in the tenets of *development economics* try sometimes, long after that strand of theory disappeared from important intellectual debates, to defend the achievements of the strategy based on its ideas. One can see it, for example,

⁴⁵ Ibid., 156.

in the long 1998 article by Henry J. Bruton.⁴⁶ He proposes a comparison of economic growth in the 1950–68 period with the 1913–50 period as the “evidence of success.” The comparison is disingenuous at best and misleading at worst.

Since *development economics*-based strategy was meant as a “shortcut,” the best comparison would have been with the same countries hypothetically pursuing standard, classical economics-based strategy. This being impossible, the second best strategy would be to compare growth rates of the LDCs (mostly pursuing the former strategy) with growth rates of developed Western market economies to see whether the developmental distance was reduced. The unpleasant arithmetic of economic growth reveals, however, an opposite outcome. The developmental distance between LDCs and Western economies, measured by GDP per capita, *increased* after WWII and this situation continued till the end of 1980s.

Thus, the “shortcut” strategy failed its basic test. Besides, the comparison proposed by Bruton was disingenuous as well. For he proposed to compare the slowest growth period in the twentieth century with the fastest growth period not only in the twentieth century, but also in recorded human history. A proper comparison I made tells an unequivocal story. Even in the fastest growth period less developed countries failed to reduce the distance to the West.

I suggest, therefore, more modesty in advertising the successes of the strategy in question! Successes are, indeed, hard to find. The first, modest, success I find in the fact that the first stage of the developmental strategy, that of the so-called “easy” import substitution, was in absolute terms—and for a large number of countries—a period of (rather slow) rise in GDP per capita, more slowly than in the West, but rising nonetheless (apart from some, extreme pathological, cases like Ghana, Guinea, and some other Southern countries).

I would also qualify as a relative success less oppressive political regimes and the reliance on markets (however strongly circumscribed) in comparison with communist countries pursuing central planning and steep ascent development strategy. These characteristics helped Southerners in coping with the adverse effects of living and working under the existing, often unappetizing, political and economic regimes.

By contrast, LDCs pursuing the development economics-based strategy could not compete in terms of performance with the economies (not so numerous in 1950–65) that made relatively early a series of institutional and policy reforms, which gave more room to markets and private entrepreneurship internally and increased the openness of their economies *vis-à-vis* world markets externally. While comparing India with, say, Taiwan and Sri Lanka with South Korea over the post-WWII period, one notes very large differences in GDP per capita in favor of the latter countries after the passage of time (in spite of the fact that they were at the same development level at the start). More will be said about these differences in the next chapter.

⁴⁶ Bruton, “A Reconsideration,” 915.

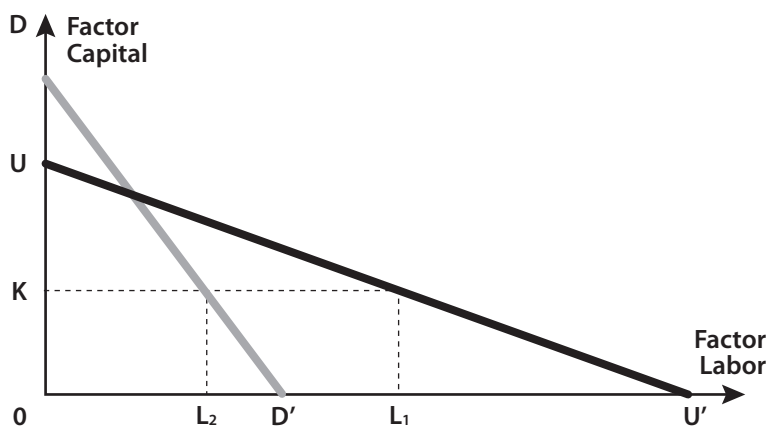
Please note that I dealt so far with large aggregates. As stressed in the previous two sections above, strategy-specific characteristics tended to create multiple distortions, adversely affecting a range of economic outcomes. Thus, apart from characteristics affecting the aggregate economic growth, many features of the strategy in question adversely affected specific outcomes. Let me single out the most distortive ones:

- *Policies severely discriminating against agriculture.* Just like some Soviet economists, a large majority of development economists favored squeezing agriculture in search of financing forced industrialization. They forgot that the known cases of accelerated growth in the West supplied the evidence of the acceleration of industry only *after* a marked increase in agricultural productivity. The net outcome for the Southern countries was a slower progress or an outright retrogression of agriculture (deprived of the financial resources needed for improvement) and the reduced flow of financial resources to governments, as agricultural surplus had been shrinking for decades. The story of agricultural marketing boards, told in Section 2.4, is a good illustration of such a trend.
- *The “illusion of greatness,” resulting from the oversized industrial sector.* Real industrial growth, measured by a share of manufacturing in GDP, was smaller—sometimes markedly smaller—than that shown in national statistics (see Table 2.2 above). Lower shares of manufacturing, measured in international rather than national prices, meant that, in reality, the sector in question absorbed more resources relative to recorded output than would have been required under less inefficient regime and strategy. In fact, the “illusion of greatness” found its manifestations not only in the lower quantity of output, but also in its lower quality, due to the nearly extinguished competition.
- *Artificially low price of capital.* Distortions were displayed also in the case of factor markets. With respect to factor capital the much too low price of capital relative to factor labor had been, so to say, consciously built into the developmental strategy. An idea of forced industrialization—the pivot of the strategy—envisaged from the start the lowering of the cost of capital to investors (state and private). Low or nonexistent tariff on capital goods, overvalued exchange rate, subsidized interest rate, etc. —all these measures were intended to reduce the price of capital in the environment marked by the scarcity of savings. What the strategy did not take into account was the usual operation of supply and demand. With too low price of a good (here: of machinery and equipment) demand for capital became too high. This, in turn, generated further distortions. Next, another distortive effect emerged because absolutely low price for capital became also a relatively low price, with adverse effect on factor proportions. It put at a disadvantage the unskilled labor—the most abundant factor in poor countries.

- *Absolute and relative high unemployment.* The idea of a “shortcut” in the process of development had as one of the economic goals the absorption of surplus labor into the productive economy. The most popular theory of the period was that of the later Nobel Prize winner W. Arthur Lewis assuming the unlimited supply of labor at a constant wage (only slightly higher than the subsistence wage in agriculture). The said theory rejected some basic tenets of economics and was criticized later in the literature on economic development. It did not work in practice and demand for urban (industrial) labor resulted in wage pressure and markedly higher urban wages. Worse still, the very strategy of forced industrialization and rapid expansion of more capital-intensive industries changed the demand for production factors.

New industries, manufacturing intermediate products and some durable consumer goods, required more capital and less labor. Moreover, labor demand shifted toward more skilled labor that had to be paid much more. The net result was much lower demand for unskilled and semi-skilled labor, because priority capital-intensive industries displayed limited demand for the abundant factor labor, while non-priority, labor-intensive industries remained underdeveloped due to the lack of factor capital. The resultant high unemployment revealed a major weakness of development economics (see Figure 2.2).

Figure 2.2. Unemployment consequences of distortions on factor markets



UU' – Price line reflecting undistorted wage/interest ratio

DD' – Price line reflecting distorted wage/interest ratio
(price of labor too high, price of capital too low)

OK – Available capital

OL₁ – Available labor

OL₂ – Actually employed labor

An empirical study of the World Bank conducted on 31 LDCs by Ramgopal Agarwala presents the effects of most economically costly distortions.⁴⁷ Here, they are presented in Table 2.3.

Table 2.3. Differential economic performance resulting from varying levels of price distortions over the 1970s (selected indicators, in %) ⁴⁸

Type of distortion	Distortions' impact upon a given variable	Large distortions	small distortions
Manufacturing protection	GDP growth rate	3.9	6.1
	Savings ratio	12.2	19.6
	Investment return	22.0	24.6
	Export growth rate	-0.7	9.5
Currency appreciation	GDP growth rate	3.2	4.5
	Savings ratio	16.7	18.2
	Investment return	15.5	25.4
	Export growth rate	2.8	4.5
Interest rate distortions	GDP growth rate	4.0	4.6
	Savings ratio	17.1	14.5
	Investment return	20.2	29.2
	Export growth rate	-0.3	5.1
Labor cost distortions	GDP growth rate	4.2	6.4
	Savings ratio	14.8	18.4
	Investment return	21.1	26.5
	Export growth rate	2.7	6.5

With highly limited positive outcomes of developmental strategy based on the ideas of “development economists” and high economic losses, the overall assessment of the strategy in practice must, inevitably, be negative. Thus an answer to the question posed in the subtitle of this section is decisive and loud NO! Rejections of some basic tenets of classical economics, errors piled upon errors both based on theory and resulting from political corruption-prone arrangements leads me to formulating the statement that the strategy in question was not worth the bother.

It turned out to be yet another, “shortcut” solution, which badly failed the people, even if somewhat less painfully than the communist system and its

⁴⁷ Ramgopal Agarwala, “Price Distortions and Growth in Developing Countries,” World Bank Staff Working Paper No. 575, Washington, DC, 1983.

⁴⁸ Source: Ibid.

associated “great ascent” development strategy. It is worth repeating that the latter was just a more extreme version of the *development economics* based strategy. Probably, the only thing that could be said to justify major errors in theory and—in consequence—policy is that both theorists and policy makers swam with the intellectual and political tide of the times.

CHAPTER 3

A Shift toward Better Understood (and Appreciated) Classical Economic Prescriptions: An Incomplete Success

Millsian “Conspiring Circumstances” and a Gradual Intellectual Conversion

Chapters 1 and 2 presented an interpreted history of two departures from the classical economics, driven in each case by the hope of finding a “shortcut” strategy, leading to accelerated economic development. The chronologically first departure, central planning plus “steep ascent” developmental strategy, constituted a near complete break with the classical economic thinking of the preceding two centuries. The second departure accepted, however grudgingly, highly constrained markets and a (very limited) degree of economic freedom. The second departure, that is, the *development economics*-based strategy, could alternatively be described as a lighter version of central planning, where development planners were forced to operate in the institutional environment of the less than free markets. Both “shortcut” strategies ended as failures, complete (communist command economy) or incomplete (development economics-based one).

Given these travails of economic thinking and policy making in the twentieth century, one could see how shockingly wrong was the then Whig (liberal) Prime Minister William Gladstone in his confident statement in 1876 on the occasion of the centenary of the Adam Smith’s great book, *The Wealth of Nations*. He proclaimed that the economists had only the duty of propagating opinions, which will have the effect of confining government within its proper province and preventing all manner of aggressions and intrusions upon the free agency of the individual.

The confidence of the liberal British prime minister of the period in the ultimate triumph of Adam Smith’s ideas had been in 1876 at best premature. In fact, it was the last quarter of the nineteenth century that began the ascendance of a range of collectivist ideas lasting about a century. Thus, a hundred years later, in 1976, markedly different sets of economic ideas had been reigning over various areas of the world. However, one is tempted to add that precisely at that time—at the close of the 1970s—some analysts (and politicians) had already been sensing a change in both the intellectual climate and public sentiment.

John Stuart Mill in his paper of 1845 stressed that ideas need “conspiring circumstances” to triumph. My intention in this chapter is to inquire both about the emergence—in fact, partly re-emergence—of economic development-related ideas belonging to the broad strand of classical economic thinking, as well as into these “conspiring circumstances” that J. S. Mill had in mind. For ideas inevitably have consequences and these consequences often generate change in intellectual climate—and, in turn, offer new ideas or bring back refined old ones.¹

“Conspiring circumstances” emerging in different areas of the world will be left for more detailed consideration in later sections of this chapter. Here, I would like to concentrate mostly on ideas. First, came a reappraisal of market prices as low-cost information carrying devices, a point stressed already in 1945 by Friedrich Hayek,² increasingly quoted in line with the growing inflation from the late 1950s till the early 1980s. As price distortions result mainly from government interventions, it became better appreciated what Ludwig von Mises stressed already three quarters of a century earlier that distorted prices distort relative cost of resources and, therefore, should be avoided as much as possible.

I think that even more important than the return to the first principles of classical economics, such as markets with undistorted prices, was another intellectual development, coming mainly from outside of the economics. It asserted that information encapsulated in prices contains information that is not only less costly than that carried by other devices, but not available otherwise.

The view in question grew out of a modern strand in the philosophy of science, more precisely from the *growth-of-knowledge* school, associated with the names of Michael Polanyi, Thomas Kuhn, and Friedrich Hayek. They maintained that a large part of knowledge is tacit, non-communicable. Although it is used by individuals in their actions, it cannot be communicated as data to others. Obviously, such dispersed, locally “bounded” knowledge (to use the term of another Nobel Prize winner Herbert Simon) cannot be aggregated and passed on to others, for example central planners. Thus, large part of data important for central planners is not accessible to them. Knowledge, partly tacit, resides in hundreds of thousands of economic agents. It is used in their decisions but cannot be reported to bureaucrats.

Worse still for central planners and, more generally, for believers in centralization of economic policy making, knowledge encapsulated in market prices is being destroyed by centralized price setting. Prices that are reduced to the role of auxiliary accounting units convey little knowledge to those who set them in the first place. Thus, central planners obtain few meaningful signals from the economy. Consequently, in the light of growth-of-knowledge theory, they depend

¹ This section is largely based on Jan Winiecki, “Intellectual Odyssey of the Twentieth Century,” *Advances in Austrian Economics*, vol. 5 (1998): 17–36.

² Friedrich Hayek, “The Use of Knowledge in Society,” *American Economic Review*, vol. 35 (1945): 519–30.

largely on their own tacit knowledge. But such knowledge residing in a small number of individuals, no matter how brilliant, is no match for the tacit knowledge of hundreds of thousands of economic agents operating in the capitalist market economy.

The most telling example is that of Poland from mid-1950s to early-1960s, when Poland became a Mecca for leftist economists from around the world. This influx was due to the fact that the best minds of socialist economic thinking were then employed in the Polish Planning Commission: Oskar Lange as the Commission's Chairman and Michal Kalecki as its most influential economic adviser. But whatever these ideological pilgrims learned as theorists, they certainly did not learn that bright planners amount to bright planning. Polish planning of the period was not distinguishable from that of other centrally planned and administered economies. The fact that it was as bad as elsewhere stemmed from the irrelevance of tacit knowledge of even the best minds employed in a planning agency.

It is worth noting that in historical debates planning was criticized for being unable to solve two major economic problems, the freedom problem and the incentive problem. But, after the elaboration of the growth-of-knowledge theory, it had been argued by some critics of planning that even if—by some unlikely historical accident—these two problems were solved somehow, planning would remain dramatically less efficient than the market anyway, precisely for reasons of irremovable informational deficiency.

The Austrian school that favors spontaneous, historically evolving, economic order over man-made order, an intellectual construction, supplied another very important argument against excessive centralization in general. It is the argument concerning the level of risk-taking, best formulated by an American, Don Lavoie.³

Lavoie contrasted the level at which economic (production) decisions had been taken through the ages. In hunter-gatherer bands, ancient despotic empires, and medieval manors, decisions were taken at the top: by tribal chiefs, emperors, and the lords of the manor. With the decision level located very high, the consequences of failure threatened a catastrophic impact on whole tribes, countries, or medieval communities. Wrong choices and resultant famines could wipe out the rulers and the ruled. Therefore, alternatives to traditional, repeated year after year decisions were exceedingly rare. The risk was seen as being too high.

The early commercial capitalism of Middle Ages changed the situation markedly. With the dominant role of the exchange economy, of prices and money, new production and other techniques were decentralized. Individuals could experiment and introduce change. If they proved to be a failure, the result would be a loss to these individuals and their dependents, not a debacle

³ Don Lavoie, *National Economic Planning: What Is Left?* (Cambridge, MA: Ballinger, 1985).

for the whole, smaller or larger, community. Experimentation became radically less costly. It was a revolutionary change (maybe one of the most revolutionary changes in human economic history!).

The problem with communist central planning—and with planning in general—was that it returned the decision-making to the highest level. The new feudal lords—as Hayek called central planners—once again, as in the past, issued commands that were compulsory for all. The consequences of the return of risk taking to the top under communism were by and large disastrous. In this sense, communist economic order was a throwback into a bygone era. It has, therefore, rightly been called “reactionary” by Friedrich Hayek.

Yet another line of economic reasoning had slowly been gaining ground since the 1960s but became intellectually more influential toward the end of the 1970s and in later decades. It was the argument that property rights mattered historically and continue to matter contemporaneously. The school of *New Economic History*, associated first of all with a Nobel Prize laureate Douglass North, supplied evidence that major breakthroughs or major changes in economic history, such as the agricultural revolution 8,000–10,000 years ago and the industrial revolution 200–300 years ago, became possible first of all because of preceding changes in the institutional arrangements with respect to property. Theorists argued that property rights, linking most closely the right to take decisions with respect to economic activity with the obligation to bear costs of that activity, that is *private* property rights, turned out to be the most efficient throughout the human history. The very fact that private property owner has the exclusive right to the surplus (or bears the costs of a loss) makes such management of property far superior to that of any other type of ownership.

Major contributions had been made in the area of property rights’ strand of economics, with important views being formulated with respect to the comparison of economic systems (at the macro level), as well as comparisons of classes of economic agents (at the micro level). Thus, not only capitalist market economy—at the level of economic orders or systems—was pointed at being economically superior, but also privately owned firms such as private owner(s)-managed firms and joint-stock companies were seen as being more efficient at the level of firms than other classes of owners, competing within the same economic system. That was an important change for up to late 1970s many economists did not see any reason why large state-owned firms should be less efficient than privately-owned firms since—according to their thinking—both were run by similarly educated individuals.

The property rights theory has contributed also to the new thinking about developmental issues. It showed both theoretically and empirically that the same quantities of production factors may generate—and, in fact, historically generated—sharply differing growth rates of GDP if property rights arrangements differed. A comparison between selected capitalist, private property-based, economies and communist, collective property-based, economies with respect to rela-

tionship between investment and GDP growth is presented in Table 3.1, proving the point.

Table 3.1. Average annual investment growth rates relative to GDP growth rates in capitalist and communist economies in the 1950–79 period⁴

Countries	Ratio of investment/GDP growth rates
<i>Selected capitalist countries</i>	
Canada	0.95
Finland	1.01
Germany (Federal Republic)	1.17
Greece	1.15
Italy	0.97
Netherlands	1.11
Sweden	1.13
Average (unweighted)	1.07
<i>European communist countries:</i>	
Bulgaria	2.00
Czechoslovakia	1.66
Germany (Communist)	2.26
Hungary	2.43
Poland	2.35
Romania	1.95
Soviet Union	1.62
Average (unweighted)	2.04

Clearly, communist countries, to generate 1% increase in GDP, had required almost twice as high a rate of investment as did capitalist market economies. Resources matter, but individuals—according to property rights’ theory—should have incentives to use them efficiently and innovatively. Thus, Michael Jensen and William Meckling stated, “It is of little importance that it is physically possible to produce 100 units of a good with some given level of factor inputs if no one in the system has the incentives to do so.”⁵ To conclude, there is more to economic growth than production function; institutions matter a lot. In real life, theorizing

⁴ Recalculated from Kornai, *The Socialist System*, 168.

⁵ Michael Jensen and William Meckling, “Rights and Production Functions: An Application to Labor-managed Firms and Codetermination,” *Journal of Business*, vol. 52 (1979), no. 4.

on property rights created intellectual foundations for the future wave of privatizations throughout the world.

Chronologically, in parallel with theorizing on property rights, another strand of theory was evolving, which led to an improved understanding of the role of the state in the economic domain. On the one hand, public choice, as well as close strands of thinking such as the logic of collective action and rent-seeking, stressed an overwhelming importance of the state as an entity creating efficient institutions: “rules of the economic game” and establishing organizations monitoring and enforcing the observance of these rules by economic agents. On the other hand, they pointed to severe limitations of the state as an alternative resource-allocating mechanism.

They stressed, first and foremost, that the government is not an abstract umpire presiding impartially over the game of economics as, e.g., a tennis umpire presides over the game of tennis. The state is the composition of individuals and groups, politicians and bureaucrats, all with their own interests that affect outcomes of political processes, just as interests of economic agents affect outcomes of market processes.

Public choice theorists demanded, therefore, that both the market and the state are analyzed in the same methodological manner and reveal costs associated with allocating resources *via* political processes within the framework of the state machinery. These costs more often than not exceeded—they stressed—costs ascribed to “market failures,” which state interventions were supposed to correct. Therefore, the public choice theorists stress the existence of both “market failures” and “state failures.” Overwhelmingly the higher costs of resource allocation through the state machinery stem, i.a., from the fact that decision-making rules tend to be much more rigorous in private firms than in state bureaucracies (in other words, agency costs are much higher in the latter).

Furthermore, in the old idealized theory of the state, politicians and bureaucrats were expected to decide solely on the basis of citizens’ interest. In a more realistic public choice approach, they take also their own interests into account. As a result, decisions are taken that are not necessarily in the best interest of citizens of the country, region, or town. This further increases the cost of resource allocation through the state machinery. Last, but not least, pressure groups spend resources on lobbying rather than producing, trading, inventing, innovating and investing. This also increases cost of political processes.

Given the foregoing intellectual contributions, one may conclude that the period of dominance of intensive state intervention after World War II had at the same time been a period of increasingly positive re-evaluation of classical economic ideas. It was also, especially from mid-1960s, a period of intellectual emergence of new strands of economics, underpinning and expanding classical economic thinking.

Developmental and other problems began to grow and multiply in all geopolitical areas of the world economy (see Chapters 1–2 above and the forthcom-

ing next two sections in this chapter). One of the effects of the combined impact of property rights theory, new economic history, Austrian school, growth-of-knowledge philosophy of science, public choice school, etc., was to supply important intellectual ammunition to those in public life who saw the adverse effects of post-WWII trends in economic policies and were searching for well-argued recommendations in favor of the return to the first principles of the capitalist market. In this way a renewal and expansion of classical economic thinking began transforming itself into a political one. Ideas began to have consequences.

Asian “Little Dragons”: Unloved Children of Developmental Success

The revival, let alone expansion, of classical liberal economic thinking was still in its infancy and *development economics*’ ideas reigned supreme in the Southern Hemisphere, when a small number of economies—altogether four—changed development strategy. The shift happened between late 1950s and mid-1960s. Its direction was identical: more markets at home and more openness *vis-à-vis* the world markets. But political conditions and attitudes behind the policy shift were different in each case.

British colonial administrators in Hong Kong in the 1950s and afterwards, responsible for economic affairs, held strongly liberal convictions. They decided—in a memorable phrase of their boss, Mr. Cowperthwaite—to pursue a policy of *active non-intervention*. Liberal (meaning not burdensome) regulatory regime, low taxes (very low by the then Western standards!), very low tariffs, and no other barriers to trade were among the most conspicuous characteristics of the city-state’s economic regime. Incidentally, the contrast could not have been greater with Great Britain itself, where the first Labor post-World War II government nationalized “the commanding heights” of the economy and introduced a very extensive regulatory regime, combined with the extremely high personal taxation levels!

Taiwan and South Korea were a different story. Each country went through the internal political upheaval. Taiwan had to reinvent itself after the collapse of the nationalist regime in mainland China and its escape to Taiwan; South Korea was economically devastated by North Korea’s invasion in 1950 and the war that ensued. Afterwards, governments in both countries pursued economic reconstruction and general developmental policy along the then fashionable lines of “development economics.” Growth was moderate by the standards of the post-WWII reconstruction period, exports minimal and consisting overwhelmingly of agricultural and some other commodities.

The only difference was the role of the United States, which for strategic reasons (containment policy *vis-à-vis* the Soviet Union) strongly supported their reconstruction and development. Apart from military aid (which had usual developmental component of familiarization with more advanced technologies), the US financial aid amounted then to about 10% of GDP or from one half to two thirds of all non-military investment. The unsatisfactory performance of these

economies raised voices in American politics that the United States should either force both countries to reform along the market economy lines or give up these “basket cases,” as they were then called by US critics. Given the US clout, the ruling elites willy-nilly—in contrast with Hong Kong!—decided on more or less cautious, but nonetheless far reaching liberalizations.

Singapore, a South-East Asian shipping and trading *entrepôt*, found itself at the developmental crossroads after the break with the rest of the Malaysia-dominated federation in mid-1960s. The socialist party ruling in Singapore then decided that the future of their city-state was not an inward orientation but the opposite path.

Korean and Taiwanese reforms were not as radically free market-oriented as that of Hong Kong, but by the standards of the day went quite far. Most importantly, reforms created for exporters a free trade regime. Since exporters often needed imported inputs and machinery, they were offered an unconstrained choice between domestic and world market suppliers. With one sweep a number of major distortions were removed. Import protection is equivalent to tax on exports. This tax was removed for exporters, even if not for all firms in the economy. By contrast, greater reliance on prices than on administrative commands became a relief for all firms. So was a policy attempting to stabilize exchange rate relative to domestic currency, since an overvalued currency strongly distorts resource allocation. Eliminating the import substitution regime did not mean the establishment of the free market one. These economies continued to be interventionist to some (varying) extent at different periods, but the change reduced costs of distortions quite considerably.

The effects were not long in coming. Exports freed from most costly distortions exploded and GDP growth accelerated as a result. Table 3.2 presents five countries in the periods before and after the shift to outward orientation. Apart from the four East Asian “little dragons,” as they were often called, Brazil was included, which had a short episode of outward orientation between two longer periods of import substitution.

A striking feature of the performance of little dragons had been that exports were manufactured exports—in stark contrast with the “export pessimism” doctrine of development economics. And, yet, there was little in this success that had not been explainable in terms of the dominant Heckscher-Ohlin version of classical international trade theory. The four East Asian high performers were poor countries, with the usual pattern of factor abundance: much unskilled labor and little capital. Opening up of such an economy, that is, a move towards free trade regime, creates opportunities for production and exports of unskilled labor-intensive goods—in line with these countries’ comparative advantages.

And this is what entrepreneurs in these countries did. They imported second-hand machinery, obsolete in the West, given the latter countries’ different factor proportions, and entered into cooperation, as suppliers, with major Western supermarket chains to make up for their lack of marketing experience.

Table 3.2. Successful four East Asian countries and Brazil: GDP and exports growth rates before and after regime change (annual averages in per cent)⁶

Country growth rates	Period	GDP	Exports
Brazil <i>a</i>	1960–67	4.1	3.7
	1968–73	11.5	16.5
Hong Kong	1963–78	8.2	9.2
Korea	1953–60	5.2	5.7
	1960–78	9.6	28.4
Singapore	1965–78	8.6	8.7
Taiwan	1960–78	8.7	20.9

Fast growth of output and exports followed. Industries and product groups in which East Asian little dragons found their advantages were then traditional light, labor-intensive industries, such as clothing, leather and leather products, sporting goods, wood products and furniture, etc.

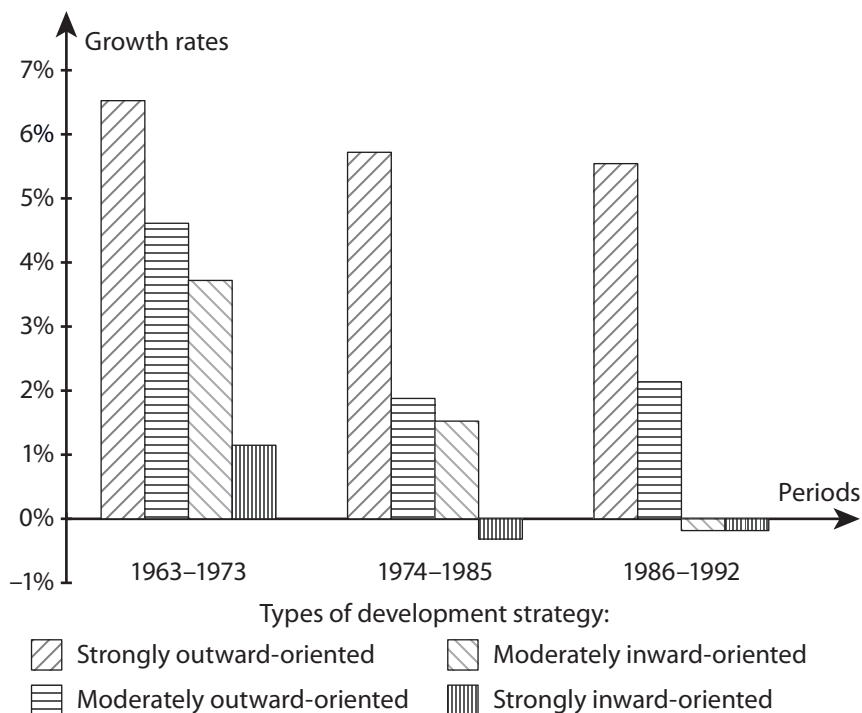
By the mid-1970s these four countries supplied half of all manufactured exports from LDCs. This somewhat surprising outcome (after all they were not large countries, like India, Indonesia, Argentina, or Brazil!) may be explained by the fact that so few less developed countries followed at that time an outward orientation path, recommended by classical trade theory. Political elites in most LDCs were still intellectually—and ideologically—wedded to thinking in terms of *development economics*. Once some other LDCs, encouraged by successes of East Asian tigers, decided to follow outward orientation, the share of the latter countries in manufacturing exports began to decline, although their exports continued to grow very fast.

Moreover, the four East Asian economies turned out also to be much more resilient to GDP and financial markets' turbulences in the world economy that surfaced in 1970s. In spite of the price explosion of mineral resources (especially oil), Western stagflation, and a changed pattern of financial flows (with large gains of OPEC countries), Hong-Kong, Taiwan, Korea, and Singapore continued to grow fast in terms of both GDP and exports. Moreover, it turned out that these four outward-oriented economies grew relatively more quickly *vis-à-vis* other LDCs in turbulent 1970s than in earlier much easier times.

This, apparently paradoxical, outcome in terms of the tenets of development economics suggested that the foregoing outward-oriented economies were

⁶ Note: a—Brazil returned to import substitution in the mid-1970s. Source: Anne O. Krueger, "Comparative Advantage and Development Policy Twenty Years Later," in *Economic Structure and Performance*, ed. M. Syrquin, L. Taylor, and L. E. Westphal (Orlando, FL: Academic Press, 1984), 135–56.

Figure 3.1. Benefits of economic openness in terms of GDP per capita growth rates in a more-or-less conducive international environment⁷



better able to weather world economic turbulences than inward-oriented ones. The latter—following the dominant doctrine—were separating themselves from the world market with a plethora of tariff and other barriers, supposedly to avoid the effects of such external turbulences. However, they manifestly failed to achieve their goals in this respect. The impact of a regime and policy choices on economic growth, supporting the foregoing assessment, is shown in Figure 3.1.

Still more interestingly, the four little dragons grew fast without stumbling into balance-of-payment crisis, despite being very sparsely endowed with mineral resources. Even more impressively, they were all oil importers and, in spite of the much higher costs of fuel imports from the early 1970s onwards, they nonetheless continued to grow faster than other LDCs.

The increasing performance gap between the four East Asian countries and the rest of the LDCs should draw attention of both economists and policy makers and generate questions about the cause (or causes) of such striking differ-

⁷ Source: World Bank materials.

ences. But for quite some time it did not. What had sometimes been called “the development community,” that is *development economics*’ theorists and practitioners from various international and national development agencies, reacted differently. First they ignored the contrast between the prescriptions of development economics and the outstanding performance of countries, which pursued the opposite strategy of more market and less commands, as well as more openness and less state control over exchanges with the outside world (via trade and later also via inward foreign direct investment).

By the late 1970s, as some LDCs started looking longingly at the East Asian high performers, the next step taken by “true believers” in the tenets of development economics was to classify four dragons’ performance as “special cases” or even luck. Incidentally, I read somewhere a Persian proverb: “Luck is infatuated with the efficient.” Thus, the correlation between luck and efficiency should not be treated as purely accidental.

Finally, and it was a masterful trick, “true believers” in extended interventionism decided to follow the example of British foreign policy makers in the eighteenth and nineteenth centuries. When the latter discovered that Britain could not beat a particular political constellation, they followed the doctrine: “If you cannot beat them, join them.” And “true believers” did the same. Since they could not negate the outstanding performance of Hong Kong, South Korea, Taiwan, and Singapore anymore, they decided to “adopt” the four little dragons as brethren in the great interventionist family.⁸ The message was that East Asian little dragons were like other interventionists, but doing it wiser. Hong Kong did not fit there, so it could be left aside and treated as a special case. The other three did intervene quite systematically and using a variety of instruments; so they were a part of interventionist crowd.

No matter how ingenuous was the adoption of the so-far-unloved children of success, three types of arguments are worth invoking here pointing in the opposite direction. Namely, that the four East Asian little dragons succeeded simply because they intervened much less than other LDCs. The arguments are historical, logical, and economic.

- 1) The historical argument has been concisely formulated by Michael Prowse, a left-leaning journalist of the *Financial Times*. He admitted that although countries he called Asian “stars” deviated from classical market norms and, indeed, intervened here and there, but so did almost all countries, less and more developed. “From the 1950s to the 1970s [...]

⁸ See, for example, Alice Amsden, “The State and Taiwan’s Economic Development,” in *Bringing the State Back In*, ed. T. Skocpol, P. B. Evans, and D. Rueschmayer (New York: Cambridge University Press, 1985), 78–106; also *Asia’s Next Giant: South Korea and Late Industrialization* (Oxford: Oxford University Press, 1989); and Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton, NJ: Princeton University Press, 1990).

the world was a very different place. In those days, the rich democracies also heavily regulated their financial markets and indulged in all kinds of domestic interventions. East Asia has tended to keep up with the times.” He added, “Since the countries that intervened less [like Asian dragons] grew more rapidly, it is hard to conclude that the interventions were hugely important.”⁹ All of the above considerations were written in reaction to a major World Bank study on the so-called “Asian miracle,” whose major conclusion was that there was no miracle, but mostly the adherence to fundamentals.

- 2) The logical argument concerns the question of intervening “wisely,” whatever that meant. Since the countries in question applied a number of well-known interventionist instruments used (and often abused) elsewhere, “the adoptionists” offer no methodology, allowing us to distill the alleged interventionist wisdom of East Asian policy makers and offer it other policy makers willing to intervene. Therefore, it is probably more fruitful to look for the usual institutional and policy fundamentals of good performance.

Some “adoptionists” looked, however, at industrial policy and proclaimed that three out of four little dragons, as well as Japan in the earlier period, promoted some industries, but not other. So, they made some economic choices in their growth-supportive policies. Indeed, a promotion of some industries—via a variety of interventionist measures—has been a staple of *development economics*-based strategy all over the South. We face, then, the same type of a problem: how to differentiate “good” industrial policy of some East Asian tigers from “bad” industrial policy of the rest?

- 3) However, an economics-based approach suggests asking “adoptionists” the following question: “How much did it matter for economic performance that these countries did intervene? Fukunari Kimura, in a recent essay suggests a negative answer: it did not matter very much.¹⁰ So do Marcus Noland and Howard Pack, who stress that industrial policy was not the key to rapid growth and the benefits from the promotion of specific industries and activities were modest at best.¹¹ Interestingly, my earlier personal discussions with some ranking Japanese bureaucrats seem to confirm the Kimura’s assessment. Thus:

⁹ Michael Prowse, “The Asian Miracle That Was Not,” *Financial Times*, September 27, 1993.

¹⁰ Fukunari Kimura, “The Japan Model of Economic Development: Relevant and Non-Relevant Elements for Today’s Developing Economies,” in *Development Success: Historical Accounts from More Advanced Countries*, ed. A. K. Fosu (Oxford: Oxford University Press, 2012), 149–70.

¹¹ Marcus Noland and Howard Pack, “The East Asian Industrial Policy Experience: Implications for the Middle East,” Peterson Institute for International Economics Working Paper 05–14, Washington, DC, December 2005.

- (a) Japanese policy indeed intervened by favoring some industries over the other (although at later times mostly through jawboning, like in the case of failed effort to deter the then motorcycle maker Honda's from entering the car market);
- (b) Japanese industries grew regardless of whether they were supported, deterred, or neglected by bureaucracies—without the superior performance of the first group.

The stories about that sort of interventions by little dragons are quite similar. They intervened, just like countries pursuing import substitution, but the effects on performance were indistinguishable from the performance of industries without such (dubious) benefits of intervention.

My personal assessment, however, goes further than just the statement on missing positive economic effects of industrial policy; these effects were *negative*. South Korea supplies interesting empirical evidence here. Of the four East Asian little dragons, the Korean elite seemed to have been the most impatient, more often ready to push for a faster, intervention-assisted structural change via wide-ranging support for some “modern,” “sophisticated” industries they wanted to establish at a given stage of economic development of the Korean economy.

Two such cases of massive intervention are worth mentioning—with the same conclusion concerning both. The first shift occurred in the mid-1970s, when policy makers decided to accelerate the development of industries regarded as “strategic” at that stage: heavy industries, such as steel, shipbuilding, autos, non-electrical machinery, as well as petrochemicals. Against the advice of some Western economists, they pushed through a program of low interest rate loans, preferential tax treatment, and later import barriers against goods competing with newly produced capital-intensive goods.¹²

As a consequence, the Korean basket of exportables shifted strongly in favor of capital-intensive goods in which Korea at that time did not yet have comparative advantages. Costs exploded, creating serious imbalances in the economy. Inflation followed, combined with wage structure distortions favoring employees in capital-intensive industries. Excess capacity in these industries run parallel to slow growth in still highly competitive light industries. The accumulating distortions, combined with some other (also political) turbulences, resulted in an absolute decline in economic growth, the first since the end of Korean War. Over the 1979–80 period, it amounted to 6% GDP. The dissatisfaction on the part of industry that so far kept the Korean economy going rapidly forward was voiced, policy changed, and the country moved back to greater reliance on markets and economic openness.

¹² See Kim Kihwan, “Kim-Jae-Ik: His Life and Contributions,” in *Liberalization in the Process of Economic Development*, ed. L. B. Krause and Kim Kihwan (Berkeley, CA: University of California Press, 1991), xi–xxxiv; and Lawrence B. Krause, “Introduction,” in *Liberalization*, ed. Krause and Kihwan, 1–26.

The impatience was stressed not only by some Western free market-oriented economists. Chen Sun, a Taiwanese economist, pointed out that Korean governments were playing “more energetic and aggressive role” than those in Taiwan in promoting industrial development. He noted, however, that “despite the aggressiveness of the Korean government and all the efforts it has made to accelerate economic development, the performance of the Korean economy in terms of growth has been no better, if not worse, than that of Taiwan over the past years.”¹³

The foregoing judgment was confirmed during the next decade. Another impatient Korean government decided in early 1990s on another “shortcut” to the next stage of economic development and the expansion of electronic and telecommunication industries, as well as a continued support for expansion of automotive industry. Going with the spirit of the times, measures of support changed to reliance on governmental credit guarantees for large firms (*chaebols*) in preferred industries, realized by the—still largely state-owned—Korean banks. With weakly exercised bank supervision by the respective agency (let me add, constrained by the governmental preferences!) lending exploded, with Korean *chaebols* attaining on average the debt-to-equity ratio about 4:1!

Since Korean banks acquired most of the capital on international markets, the level of indebtedness of Korean banks and industrial firms was evaluated at some point by financial markets as dangerously high. The credit crunch, accompanied by a foreign exchange crisis, ensued. It was a part of a larger phenomenon as more Asian economies fell into similar trouble known as the Asian financial crisis. In contradistinction to the opinion that markets, this time international financial markets, are guilty (as usual!), a cool judgment should be that the crisis in question was yet another case of governments messing up with the national economies in many ways, differently in, for example, Korea, or Thailand, or Indonesia.¹⁴

Interestingly, there was—again—a notable difference between Korea and Taiwan. The aggregate consequence of yet another premature shift to more advanced industrial output structure for Korea was a fall in GDP by about 6% in 1997–98. Taiwan was also affected, but only indirectly, as exports to crisis-ridden countries of the region declined sharply, while devaluated won made Korean goods more competitive in third markets in comparison with Taiwanese ones. But Taiwan did not suffer from GDP decline. Altogether, in spite of almost parallel timing in the early shift to outward orientation, Korean “shortcut” ventures and their economic costs resulted in permanently higher Taiwanese GDP per capita in comparison with the Korean one by approximately 10–15% (approach-

¹³ Sun Chen, “The Role of Medium-term Plans in Development,” in *Liberalization*, ed. Krause and Kihwan, 159.

¹⁴ For a brief summary, see Jan Winiecki, “So Much for Interventionist Utopias,” *The Asian Wall Street Journal*, March 10, 1998.

ing at times 20%). Returning to more general conclusions stemming from the experience of the East Asian little dragons, this “intra-dragons” comparison also suggests that these countries surged forward in growth, structural change, and exports because they intervened less than those pursuing import substitution. If they occasionally intervened more, like Koreans in the two aforementioned cases, they paid a steep price for their impatience.

The foregoing experience of (South) Korea should be offered as a warning to those policy makers who would be willing to listen to the new wave of sirens’ voices about “new,” “modern,” “sophisticated,” etc., industrial policies. The ideas of Dani Rodrik¹⁵ and others contain the core of the same utopian thinking. This time the thinking of how the state can mastermind the market and tinker with its private participants’ decisions...

Growing Adverse Consequences of Post-WWII Ideas: The Triumph of “Conspiring Circumstances” from West to South to East

The brief overview of the dynamics of Millsian “conspiring circumstances,” which cleared the path to a major intellectual turnaround in economic thinking, starts with the West. Not because here the distance from the old, classical and new, supportive thinking and actual policies had been the largest. On the contrary, in spite of some major departures, it was the smallest. The rationale for such choice is that the West has played an indispensable part in the whole process.

There were two interrelated reasons of the West’s importance, one of them somewhat more obvious than the other. The first reason was that the West had been at the time the only democratic area of the world and voters there could register their economic discontents through the ballot box. New, classical liberal/conservative coalitions came to power in many Western countries. No less often, old coalitions and parties changed their policies to some, at times substantial, extent, when confronted with adverse economic effects and a change in the sentiments of the general public.

The second, somewhat less obvious, reason was also related to political freedom. Intellectual freedom may survive (for some time!) without political freedom, but political freedom entails intellectual freedom as a matter of course. Therefore, it is not surprising that the intellectual underpinnings, outlined above in Section 1, of the shift away from the excessive reliance on planning, governmental intervention, public ownership—and the state in general—were formulated mostly in the West. Contributions from the South and the East were incomparably smaller.

How the Western world accumulated economic problems that generated growing discontent is a well-known story and I can only highlight the

¹⁵ See Dani Rodrik, “Industrial Policy for the Twenty-First Century,” Harvard University, September 2004.

most important points briefly. Thus, more than two decades of Keynesian macroeconomic stimulation at times of economic slowdowns and little restriction at times of overheating led to persistent inflation. This, clearly demand-driven, inflation was rising from one business cycle to another during 1950s and 1960s, due to both growing scale of the fiscal stimuli and declining “monetary illusion.” Economic agents were shifting to adaptive inflationary expectations.

In the overregulated post-WWII world, highly intrusive regulation of private economic activity (by Western, not Southern or communist standards, though) led often to a high cost of doing business. The rigidities resulting therefrom gave rise to the spreading opinion of *Eurosclerosis*, as Western Europe went farther than the United States in regulatory expansion.

The monopolistic, inefficient public sector chronically underperformed and required increased subsidization. A large part of the fiscal crises of the 1970s (in many cases just patched-up, not solved until today)¹⁶ was due to that inefficiency. Excessive expenditures for the ever expanding welfare state and fiscal support for the state sector in the economy prompted most Western governments to repeatedly increase taxes.

Overregulation and growing taxation weakened over time incentives to work, earn, save, and invest. There was a decline in entrepreneurial dynamics, adversely influenced also by a hostile macroeconomic environment of high inflation, high interest rates, and the crowding-out of private businesses by national treasuries.

As interventionism continued *en masse*, while economies slowed down markedly, a new interpretation was offered of the sources of high economic growth in the early post-war period (1945–70) that pundits ascribed earlier to successful state interventionism.¹⁷

First, high growth was an effect of the delayed wave of innovations from the period of Great Depression and World War II (where inventions were not applied for civilian purposes). And, second, it was due to a special—and in the 1970s just passing—period in economic history when manufacturing industries based on scale economies were the main engine of growth. With productivity increasing, on the average, 20–30% with each doubling of productive capacity, declining entrepreneurial dynamics was not perceived at the time to be a recognizable barrier. However, with the ongoing shift of the economic growth’s engine role to innovation-, quality-, and customization-based industries, the effects of weakened entrepreneurship began to be felt much more strongly.

Finally, the state—that mythical guardian of public interest—turned out to be very sensitive to various special interest groups, with politicians and bureaucrats more often than not maximizing their own goals rather than those of the

¹⁶ See Winiecki, *Economic Futures of the West*.

¹⁷ See Andrew Shoenfield, *Modern Capitalism: The Changing Balance of Public and Private Power* (Oxford: Oxford University Press, 1965).

electorate. The *public choice* and similar strands of economic thought helped since mid-1960s to demystify the state and put it in comparative perspective with the market.

The years of discontent, as late 1970s were often called in Western Europe and the United States, were a watershed. The time for Millsian “conspiring circumstances” had arrived and the political change, underpinned by the return to classical, capitalist market-based ideas, led in the next two decades to significant economic changes.

The discontent with *development economics*-based ideas in the Southern, or the then “Third World,” countries had been accumulating at least since mid-1960s, when the easy phase of import substitution ended (see above, Chapter 2) and growth of economic problems began to be more painfully felt. However, the discontent was less well-articulated in economic terms and more diffuse, given the plethora of distortions generated by *development economics* prescriptions. Moreover, it was less directly felt in the realm of politics, given the undemocratic governance regimes in most LDCs in those times.

Undoubtedly, the tenet of “export pessimism” with respect to manufactures began to be seen as decreasingly credible as year-after-year of export successes of East Asian high performers proved that there are few constraints on their export drive—if exports followed exporters’ comparative advantages. Thus, a growing number of ruling elites throughout the South were looking with interest at the dragons’ foreign trade and GDP growth, considering adjustments in the so far pursued developmental strategy. The numbers of those governments brave enough to face the opprobrium from the still large majority of “true believers” in the tenets of development economics in both academia and the policy practice was rather small in 1970s, but it grew in 1980s and later.

However damaging (see the last two sections of Chapter 2), the export pessimism-related distortions were not the only ones. Many other were also recognized with the passage of time. They were also considered in the preceding chapter. For the ruling elites the message from the growing part of the research on the subject was quite clear: it is not adjustments to the existing developmental strategy, but the *change* of strategy that was required. Without such change, outward orientation may not succeed as well as it did in the East Asia star performers.

However, the recognition of the existing range of distortive components of the pursued strategy did not mean that policies aimed at correcting these errors were promptly (or at all!) introduced. Policies damaging even for the development economics-based strategy, let alone damaging the growth prospects, continued long after their recognized failure. The best presented answers to the question of why bad policies persisted for so long can be found in the studies by Anne O. Krueger, especially in her Princeton 1992 lectures.¹⁸ However badly designed and even worse implemented, various distortions entailed not only costs for all,

¹⁸ Krueger, *Economic Policy Reforms*, esp. lectures 2 and 3.

but also benefits for some (see Chapter 2 above). And it was the (often highly placed) beneficiaries who defended these harmful policies.

Consequently, the example of East Asian little dragons, combined with the growing recognition of costly distortions in the so far pursued strategy, did not result in a rush to the greater role of markets and greater external openness. A range of differentiated attitudes emerged in 1970s and 1980 with respect to the strategy change in less developed countries.

The first (limited) set of countries had been *bona fide* reformers who looked with admiration at the successes of the East Asian little dragons and were ready for a strategy change to outward orientation. They realized that the early development strategy was erroneous and economic growth and related “goodies” would have been higher if early errors had been avoided. The degree of success of the shift they were ready to implement would be different in each individual case, depending less on the proper institutional and policy changes, but more in the scale of resistance of those who had vested interest in maintaining the inefficient *status quo*.

The second, probably the largest, set of LDCs was composed of those ruling elites who still looked longingly at the tenets of “development economics,” but realized at a certain point that costs of sticking to that strategy were increasingly high, while benefits were shrinking simultaneously. Some had primarily the well-being of population in mind, while the other mostly their own benefits. But, in both cases, the strong belief in the superiority of governance from the center and in other tenets of “development economics” made them very cautious in introducing changes that outward orientation required.

In the countries in question the very probability, as well as the degree, of success was handicapped in two ways. Firstly, the distrust in the liberalizing pro-market and pro-openness measures might have resulted in the introduction of the incomplete minimum of institutional and policy changes required. And, secondly, the distrust in question affected also the practical pursuance of the strategy. Always on the lookout for real or imaginary faults in the new strategy, rulers were ready to abandon the recently introduced changes at first signals of something going wrong or only the appearance of going wrong. Errors might have been the outcome of incomplete change, but their interpretation by the rulers was different: the new strategy was not working. And these handicaps were completely independent of the resistance of vested interests, which in themselves adversely affected the prospects of success.

The third set of LDCs was a peculiar one, best defined by Deepak Lal.¹⁹ In his view the growing extent and depth of government control—he uses the French term *dirigisme*—led over time, paradoxically, to the shrinking ability of these governments to control the economy. It is not surprising: the wider the range of areas of control, the weaker the grip on particulars of the all-embracing

¹⁹ Deepak Lal, “Political Economy of Economic Liberalization,” *The World Bank Economic Review*, vol. 1 (1987): 273–99.

bureaucracy. The more taxes, for example, the smaller the registered economy and the larger the shadow one.

Thus, a phenomenon that Lal calls the “the unMarxian withering away of the state”²⁰ began. Especially for the elites in the Northian “predatory states,” such dynamics threatened the opportunity to live off the state. The rulers considered at a certain point—says Lal—the costs of *not* liberalizing to some extent the rapidly vanishing registered economy.²¹ Thus, some liberalizing measures were introduced in order to regain a degree of control over the economy. Sometimes there were side benefits in such liberalizations in the form of foreign aid coming as a reward from the World Bank or other agencies managed by “bloody dogooders.”²² Of course, under such circumstances, predatory states rarely if ever succeeded in changing the strategy to a really successful one. For an even relatively free market and economic openness would have sharply contracted or even deprive the kleptocratic elites of the opportunity to live off the state.

In the third, most strongly separated, part of the world economy, that is in communist countries, problems also began to grow more serious over time. The range of reforms in Eastern and East-Central Europe that had been aimed at alleviating the most costly systemic distortions began with Hungary in mid-1950s and Poland soon afterwards and ended with the Soviet Russia, Czechoslovakia, and the communist German Democratic Republic in mid-1960s. None of them solved any of the major deficiencies, because their sources were embedded in the very basic communist institutions: state ownership, bureaucratic coordination of the economy, and political control, which were the taboo throughout the whole existence of the Soviet-style communism. Moreover, Czechoslovak reforms in 1960s went out of control, began to move more and more into the political territory, and ended in 1968—as everybody knows—with the Soviet invasion of Czechoslovakia.

Accordingly, the Soviet communist elite lost the appetite for further major overhauls of the centrally planned and administered economy and other, subordinated, communist elites in European dependencies of necessity followed suit. “Tinkering—yes; major reforms—no!” was the message. The wasteful, resource-intensive, anti-innovative economic growth, generating permanent excess demand and structural distortions continued.

But soon, at the threshold of 1970s, ruling communists discovered the substitute to reform in a modernization strategy based on external borrowing of everything: capital, more modern technology, and the rest from the West. In return, communist command economies would pay Westerners back with

²⁰ Ibid., 283.

²¹ Ibid., 282.

²² For similar reasoning on aid and predatory governments, see books by William Easterly, the earlier quoted *The Elusive Quest for Growth* and *The White Man's Burden*. And, of course, the already quoted old 1968 book: *The African Predicament* by Andreski.

exports of the products manufactured in the new plants built with Western capital and applying Western technology.

This idea had very serious disadvantages, obvious for all Sovietologists, except those who were eternally in love with the system. First, the institutions of the system were inimical to innovations and for the same reasons would also be inimical to imitations. The intrusions into current production (see Chapter 1) would be resisted, regardless of the source of these intrusions—domestic or foreign technology. Second, importation of capital makes sense when other cooperating production factors are available. But command economies displayed excess demand across the board. So, building and manning new plants encountered difficulties, translating into cost increases and long delays. Sometimes the newly bought technology became obsolete before production started.

Jean Walbroeck in his survey of development economics²³ joked about the “fashion for buying turnkey plants” in the hope that “they would prove as productive as plants in the North.” In command economies the story was similar, only problems were amplified by the systemic features, such as, e.g., permanent excess demand. Furthermore, not only plants went into operation with long delays, but also production was of lower quality due to the disincentives to quality in the communist economic system. Thus, command economies learned—with a lag—the import intensity costs of import substitution—a problem signaled with respect to Southern economies in Chapter 2.

The whole story ended with high volume of debt and much too low levels of exports relative to the incurred debt,²⁴ and contributed to the already visible economic deceleration and aggravating distortions. Economic deceleration for the Soviet Union was shown in Table 1.3 in Chapter 1 above. As for distortions, estimates of real wages and longer queues indicating growing shortages pointed to the declining living standards since the mid-1970s across the whole European communist world.²⁵ Soviet Russia, thanks to the explosion of fuel prices in 1970s suffered less, for it did not experience balance-of-payment crises (and in the case of Romania and Poland also default on their debt). But all smaller East-Central communist economies suffered strongly from belt tightening.

It became increasingly clear for some observers that the *mane-theke* was already on the wall of the communist system. This was, in fact, what I tried to tell the readers of my articles in *Soviet Studies* in 1986 and in *Economic Prospects* in 1987.²⁶ My scenarios were pointing to the timing of *The End* and a systemic

²³ Jean Walbroeck, “Half a Century of Development Economics,” *The World Bank Economic Review*, vol. 12 (1998): 323–52.

²⁴ Winiecki, *The Distorted World*, Chapter 6.

²⁵ See Winiecki, *Economic Prospects*, Part I.

²⁶ The articles are the following: Jan Winiecki, “Are Soviet-type Economies Entering an Era of Long-term Decline?” *Soviet Studies*, vol. 38 (1986), no. 3, 325–48; and “Soviet-type Economies: Considerations for the Future,” *Soviet Studies*, vol. 38 (1986), no. 4, 546–61.

change that I predicted to happen in the first half of 1990s for Soviet dependencies. The actual timing was 1989 for smaller communist economies and 1991 for the Soviet Union. The only surprise for me was that the Soviet Union followed its dependencies in so short a time span. The subjects in smaller East-Central European countries and Russians themselves owed the accelerated Soviet collapse to the fumbling of the “pink panther” of decaying communism—Mikhail Gorbachev. Whatever he touched in his political and economic decisions fell down like a proverbial house of cards.

It is interesting to note that problems with the pursued strategies and macropolicies were aggravated roughly in the same period all over the world. The inflationary outcomes of the Keynesian policies became increasingly painful by late 1960s, while the regulatory burden—resulting in growing rigidity of Western economies—revealed its side effects during the two oil shocks in 1970s. The discussion of Eurosclerosis and the first debates on American decline arose toward the end of that decade. By the turn of 1980s the Western world was ripe for the enhancement of markets, prices, competition, private property, and other institutions of the Smithian system of natural liberty.

In contrast with the West, which suffered, by and large, from a different set of troubles of mature economies, the distortions resultant from the developmental strategies in the East and South were basically similar in both command economies and LDCs pursuing development economics-based strategy as it has been signaled throughout this chapter. After all, both groups of countries were composed of less or middle developed economies and the similarity of “short-cut” strategies made side effects and final outcomes also similar to some extent. Although the pundits concentrated on West-East comparisons (misled by the military position of Soviet Russia), economic comparisons made sense mostly between command economies and less developed ones, as I stressed at the end of the 1980s.²⁷

Now, let me summarize the West, South, and East development-related stories outlined in this section. The West had been the only place at the end of 1970s, where economic, political, and other discontents could be channeled through the ballot box. Therefore, the Millsian “conspiring circumstances” could be much earlier transformed into political changes leading to capitalist market- and economic openness-centered institutional and policy reforms.

The less developed economies presented a more checkered picture. The first group of market- and openness-oriented economies started their reforms even earlier than the West (see the preceding section in this chapter). But the conversion of other countries was an uneven process, changing not only over time (increasing number of conversions from one decade to another), but also

²⁷ See Jan Winiecki “STE-LDC Comparisons: A Neglected Field of Comparative Systems Analysis,” *Communist Economies*, vol. 1 (1989), no. 1, 61–77.

differentiated by the degree of acceptance of market and openness, as well as true motives in undertaking reforms.

Finally, the communist system turned out to be most resistant, because of the tightest, totalitarian control over its subjects. However, threatened with the collapse under the weight of its own incompetence, rulers softened their grip and the result was the end of the Soviet-dominated system in the very short time span of less than three years. *The triumph of Millsian "conspiring circumstances" throughout the world was near complete by 1991.* The sometimes contested changes in communist China and India will be given special consideration in the following section.

Two Cheers for an Open Capitalist Market Economy: Why Is Success Incomplete So Far?

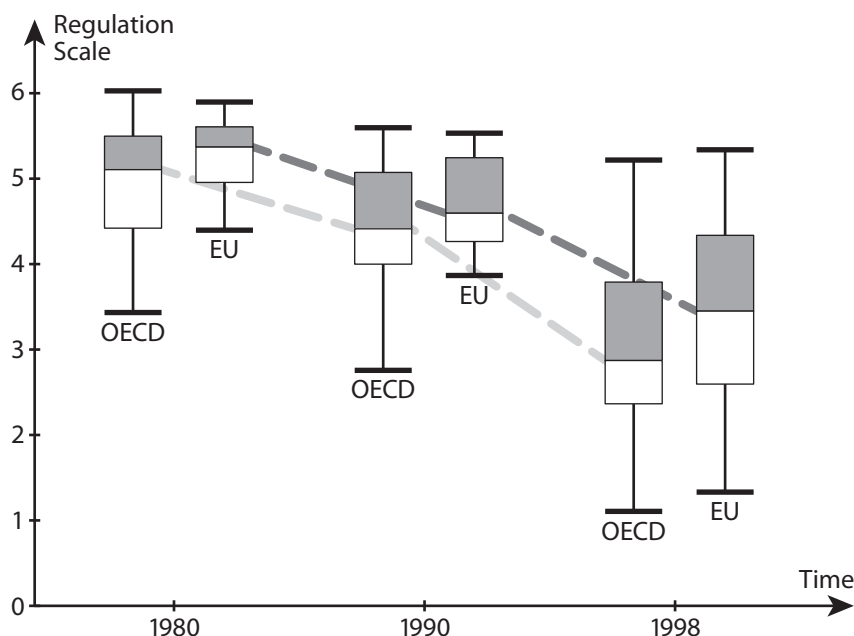
The return to markets, prices, competition, private property, and other characteristic features of the capitalist market economy proceeded from West to South to East in each case from a different level economic freedom in different countries and at different speeds. As stressed in the preceding section, the process of reform and changes began the earliest in the West. The dynamics of the process was uneven, though.

The liberal, free market counterrevolution, as reforms in the United Kingdom and the United States under Thatcher and Reagan were often called, resulted in a more wide ranging freedom of the market in these two and other Anglo-Saxon countries than, say, in continental European countries, with their much longer history of statist policies, higher taxes, and more restrictive regulation. Within continental Europe Scandinavia, Netherlands, as well as Spain under the liberal-conservative government of Prime Minister Aznar, made much greater efforts to liberalize their economies than other continental countries.

The march of economic freedom was nonetheless uneven across various economic indicators. It was, for example, much more advanced with respect to deregulation. Figure 3.2, presenting the deregulation process from 1980 to 2000 in the West, points to the continuous reduction in the extent of regulation in the production area. It was faster in OECD countries than in the EU countries, because the former included, apart from the United States, also rapidly deregulating New Zealand and Australia.

The return to economic freedom did not look as promising with respect to taxes and public expenditures. Some European countries, particularly those strongly pressured by their very high public expenditure/GDP ratios (PE/GDP for short), tried to put some limitations on public expenditures, particularly those allocated for a variety of welfare expenditures. And, indeed, politicians in Sweden and Finland, trying to cope with the crises on their hands, markedly reduced the ratio in question throughout the 1990s and beyond (yet the PE/GDP ratio was still high even by West European standards also after the reforms). In

Figure 3.2. Declining levels of regulatory intensity in OECD and European Union countries in the enterprise sector from 1980 till the end of the century²⁸



a number of countries fiscal effects were smaller (like, for instance, in Germany in mid-1990s) or only temporary. Besides, in the second half of that decade, the process had been reversed and the PE/GDP ratio began again to inch upwards (and further accelerated since 2008, that is with the advent of the so-called Great Financial Crisis). Thus, while the regulatory side underwent quite substantial liberalization, changes on the expenditure side were often cosmetic, without much progress in institutional terms.

Let me remind the readers about an earlier observation that there were marked differences in the degree of liberalization among Western economies. Inevitably, they had an impact upon economic growth. The two most radical “free market counterrevolutionaries” changed their positions in the pecking order of economic growth rates. A good comparison is between the post-WWII quarter

²⁸ Notes: Presented on a 0 (least regulation) to 6 (most regulation) scale. The average level is shown by the line between the grey and white oblongs. Extremes are shown by horizontal upper and lower lines. Source: G. Nicietti and S. Scarpetta, *Productivity and Growth* (Paris: OECD, 2003).

of a century (1945–70) and that between 1980 and 2005 (the pre-“Great Financial Crisis” quarter). During 1945–70 four major West European economies (France, Germany, Italy, and the United Kingdom) were catching up with the United States in terms of GDP per capita. However, during 1980–2005, the United States grew on the average by almost one percentage point faster than the four European countries in question. Moreover, the United Kingdom, which lagged the other three West European countries during an earlier quarter of a century, turned into a leader in economic growth among them during the 1980–2005 period.

In fact, some other liberalizers, for example Ireland and Spain, grew much faster than both the United States and the four largest West European economies. (I excluded Australia, which also grew markedly faster than continental European powers, but in that country’s case there was an additional growth-enhancing factor, namely sharp acceleration of external, primarily Chinese, demand for Australian mineral resources.)

As for the countries of the South, a range of modifications of the developmental strategy pursued so far by LDCs (and differing motivations on top of strategic choices!—see above) make generalizations more uncertain than those concerning other areas of the world. We may, however, point to certain uncontested positive changes.

The first concerns the death of the long standing “export pessimism.” Trade elasticities, particularly in the longer run, are “virtually infinite” for countries able to not only expand but also diversify exports over time.²⁹ Already by 1987 the share of manufactures in the commodity composition of LDCs’ exports amounted to 56%, a two and a half times greater share than twelve years earlier (in 1975), when only four countries (Asian dragons) exported half of all manufactures from the South. An interesting piece of evidence of the reversal of worries expressed by many “development economists” in the past can be found in the 1995 article with the dramatically sounding title: “Are Your Wages Set in Beijing?”³⁰ Toward the end of the twentieth century it was rich countries of the West that were worried whether they were able to compete on international and their own markets in traditional manufactured products with the poor and not so poor LDCs.

More fundamental, albeit less researched empirically, have been the changes in the economists’ perspective on the reaction to incentives by workers in the South. As pointed out ironically by Jagdish Bhagwati, another pessimism had vanished as well, namely that “the underdeveloped areas were inhabited by a species that belonged doubtless to homo sapiens but which had no claim to the virtues with which the Economic Man (reacting to incentives) was endowed.”³¹

²⁹ Quote from Walbroeck, “Half a Century of Development Economics,” 332.

³⁰ Richard B. Freeman, “Are Your Wages Set in Beijing?” *Economic Perspectives*, vol. 9 (1995), no. 3, 15–32.

³¹ Jagdish Bhagwati, “Development Economics: What Have We Learned,” *Asian Development Review*, vol. 2 (1984), no. 1, 27–8.

The foregoing “discovery”—pointed out (tongue in cheek) by Bhagvati—applied also to poor farmers in LDCs, so often criticized in the past for allegedly being impervious to changes in economic incentives.

The next tenet of development economics that also disappeared in the more recent period was the alleged dearth of private entrepreneurship in the South and the conclusion drawn at the time that public entrepreneurship should substitute for the missing private one. I raised this point earlier with respect to Asian dragons (see the section on “Asian ‘Little Dragons’” above). Subsequent decades proved, however, that entrepreneurs, given half a chance by the—so often predatory—ruling elites, would recognize the opportunities, take the risk, and prosper all over the South, not only in a small selected group of East Asian high performers.

When, on the verge of 1990s, post-communist countries entered the field of systemic transition it became possible to conclude that the shift to the institutions and policies of the capitalist market economy triumphed, to a smaller or greater degree, throughout the whole world. It was summed up in a following manner: “the same principles . . . that work in OECD countries should be valid (also) for less developed countries and cultural differences can no longer be invoked to justify profligate or simply unprofessional policies.”³²

This turnaround from statist, interventionist ideas to those much closer to classical economics was registered even in economic terminology. The so-called “Washington consensus,” a set of institutional and policy ideas, reflecting a *minimum* agreement among economists working in the academia and international financial organizations in and around Washington, DC, was renamed after the collapse of the Soviet communist system in Europe as “The One World Consensus.”

The consensus was somewhat limited, as my own experience proved in the spring of 1989. After almost a decade of refusals by communist authorities I was then allowed to leave my country together with my wife, who usually was treated as a kind of hostage and refused the right to travel together with me. At the time I was already known as an economic dissident and critic of the communist system, publishing a lot in the West. Thus, when I arrived to Washington, DC, I was invited to a business breakfast with the middle level managers of the World Bank. People began to enter the meeting room and one of them, a reddish-skinned Swede, marched straight to where I stood and declared right after introducing himself—and in an irritated tone at that—that he “cannot understand why all countries around the world want to become liberal democracies and market economies.”

I later learned from a variety of encounters with the members of the “development community” that the believers in statist interventionist ideas continued to

³² László Csaba, *The New Political Economy of Emerging Europe*, 2nd ed. (Budapest: Akadémiai Kiadó, 2007), 98.

be quite numerous in both the academia and international organizations. None, however, was as explicit in his or her skepticism as this Swedish socialist (or communist, given his distaste also with the democratic political regime!).

Irrespective of the distaste of some diehards, the countries shifting away from communism toward democracy and the market were more homogenous and less numerous than the countries of the South. Therefore, generalizations about them and their performance on the path to achieving these goals are more precise and better evidenced as well. First, it should be noted that, even after changing the political system, post-communist countries faced greater hurdles in their march to the capitalist market and economic openness.³³ Thus, instead of reforming their economies, that is eliminating distortions imposed by collectivist institutional intrusions and policy measures, they faced the task of *changing* the economic system. Undoubtedly, a task made more difficult since it is easier to remove distortions, even institutional, in the existing economic system than to build the whole institutional edifice of the capitalist market from the scratch.

Also, the extent of privatization was infinitely larger in the East than in both the West and South. The range of privatized state-owned productive assets amounted to between 80% and 100%, while the largest privatizations in the West concerned some 5–10% of all assets and in the South—more than in the West but rarely exceeding 15–20% of the total. These facts, plus half a century of vitriolic anti-capitalist propaganda, created major obstacles to successful transition. Many economists and other analysts regarded them as almost insurmountable.

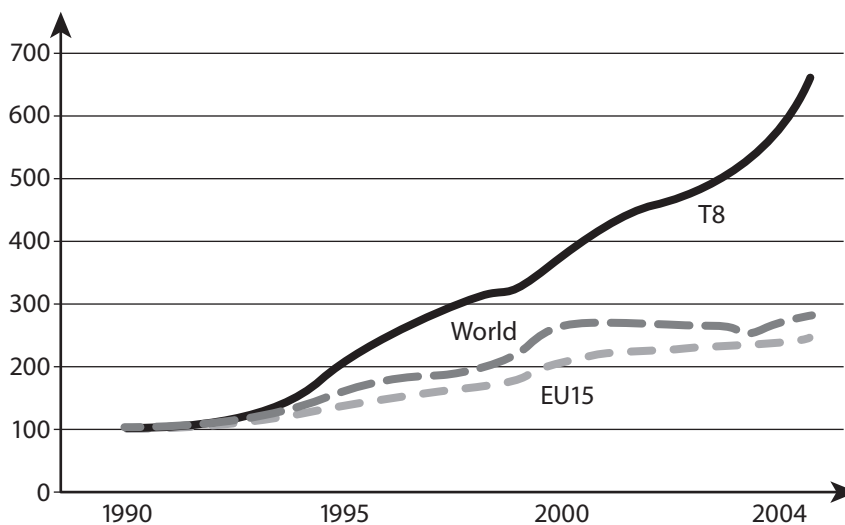
There were, however, some generally underappreciated informal institutions improving the prospects of successful transition. First of all, the post-communist countries could be divided into two areas. The first, stretching from Slovenia in the southwest to Estonia in the northeast, was that part of the post-Soviet world whose elites and societies regarded themselves, by and large, as the part of the West from which they were forcibly detached by the Soviets. They wanted to return to where they belonged as far back as in their medieval past.

Being a part of the same civilization helped a lot. There were no formal institutions of the capitalist market, destroyed almost completely by the years of communism, but there were still, albeit weakened, informal institutions: the belief in political and economic freedom, rule of law, and private property. From there stemmed the will to proceed as fast as possible with the transition. Nowhere in the world, among countries shifting to more market and more openness, the readiness to undertake such a daunting, politically costly task was greater than in that group of countries. Moreover, it helped that they had been middle-developed countries, with relatively high levels of educational attainment, and as such better able to adapt the structure of their economies to the demands of international markets.

³³ Leszek Balcerowicz, "Post-Communist Transition: Some Lessons," Thirty-First Wincott Lecture. London: The Institute of Economic Affairs, 2002.

Thus, the potential for successfully coping with the systemic change (however costly it might have been) was there. Moreover, Hungary, Poland, Czechoslovakia (later the Czech Republic and Slovakia, after the velvet divorce in 1993), Slovenia and three post-Soviet Baltic republics: Estonia, Latvia, and Lithuania were helped also by the advantages encapsulated in the gravity model of foreign trade. That is in their proximity to the very large market of Western Europe (and the institutional attraction of the European Union, then called European Economic Community). Figure 3.3 showing the share of these 8 countries exports in the European Union and the rest-of-the-world imports reveals the very much larger share in imports of the former. Geographically close markets helped these countries' exports, while civilizational proximity helped, in turn, their inward FDI.

Figure 3.3. Export dynamics of transition leaders (T8) until their entry into the EU relative to European Union (15) and world exports, 1990–2004 (1990=100)³⁴



By contrast, other post-Soviet transition countries, as well as the Balkan ones encountered civilizational problems, beginning with the post-Soviet Russia.³⁵ I stressed in my earlier work the sharp divide between countries belonging to Western Christendom and those belonging to the Eastern one.³⁶ The dif-

³⁴ Source: Based on statistics presented in Jan Winiecki, ed., *Competitiveness of New Europe: Papers from the Second Lancut Economic Forum* (London: Routledge, 2009).

³⁵ See, e.g., László Csaba, "A Decade of Transformation: Russia and Hungary Compared," in *A Liberating Economic Journey*, ed. A. Brzeski and J. Winiecki (London: The Cromwell Press for CRCE, 2000), 99–140.

³⁶ See, first of all, Jan Winiecki, Vladimir Benacek, and Mihály Laky, eds., *Private Sector after Communism* (London: Routledge, 2004).

ferences existed for the thousand years in the relationship between the temporal and transcendental power, for not much shorter time span in the extent of economic freedom, as well as in the role of private ownership of productive assets. Russia itself formally accepted private ownership—and only for the upper and middle classes at that—under the rule of Catherine the Great in the late eighteenth century! Even if some countries belonging to Eastern Christendom joined the European Union (as did Bulgaria and Romania), they continue to face serious adjustment problems with respect to formal (and even greater with respect to informal) Western institutions.

Successful transition to liberal democracy and a capitalist market economy have been accomplished, in spite of some glitches here and there at various times, only by the eight countries of East-Central Europe. The remaining post-communist countries continue to go through the long adjustment period, which may last decades (or more).

The eight middle-developed countries in question are, in fact, success stories comparable to the four dragons of East Asia. By the turn of the twenty-first century, that is after barely 7–10 years since the start of systemic change, they were already regarded as fully-fledged liberal democracies (a status the four dragons have not yet reached, even now), while their economies undoubtedly are both market economies internally and open externally. Some critics may raise the objection that they did not register long periods of very high economic growth as did four Asian dragons, but my rebuttal consists of two parts:

- First, the countries in post-communist transition had to shed the deadwood of communist production for production's sake: goods not demanded under the market structure of incentives.³⁷ From there came very large GDP and especially industrial output declines in the early years of transition. These declines shifted the long-term average growth rate downwards. Since declines were sharply different across sectors and industries, the process of structural change was also much more turbulent in transition economies.
- Second, the gravity model explained rapid export expansion to Western Europe, but could not take into account that the foregoing success stories are located in the geographic proximity to Western Europe, which became a part of the world with the pronounced tendency to ever slower economic growth during the past 4-5 decades. Strong foreign trade and foreign investment linkages with the slow growing countries, trending toward stagnation³⁸ put a ceiling on the economic growth prospects of countries strongly dependent on these linkages, and an ever lower ceiling at that.

³⁷ See Jan Winiecki, "An Inquiry into the Early Drastic Fall of Output in Post-communist Transition: An Unsolved Puzzle," *Post-Communist Economies*, vol. 14 (2002), no. 1, 5–29.

³⁸ See Winiecki, *Economic Futures of the West*, Chapters 6 and 9.

- A third part of the explanation has been supplied by Yegor Gajdar, an academic and (for a very short period) a policy maker. He explained that a transition to the market without a period of severe output losses may succeed only at a low level of economic development, when there are still opportunities for rural labor to move to the cities and work in manufacturing. The resulting increase in industrial output would compensate the lost industrial output due to the elimination of unneeded production in heavy industry and closure of unviable enterprises in these branches of manufacturing. For middle-developed economies, where the shift of labor from agriculture to industry has almost been completed, such a loss-free shift is not possible anymore.³⁹

The intellectual travel throughout the world, where there had been a shift in the development strategy toward the greater role of markets, competition, private property and economic openness, would be incomplete without the most important of recent additions to that process. I mean the institutional shifts in communist China and India. I stress the institutional side of the story, because there exists an (erroneous) tendency to concentrate on outstanding (China) and good (India) growth performance to the detriment of studying the causes of these welcome outcomes. Worse still, some West-haters propound the thesis on the emerging “Beijing consensus” at the roots of China’s economic success as being allegedly better than the prescriptions of Washington consensus (later One World consensus).

The reality is different. Just like with the Asian dragons, whose successes were first ignored, then ascribed to luck or accidental developments, and later adopted as another version of interventionism, we see the same pattern of “adopting” communist China (and, maybe, India as well). Although the old Marxian slogan “Proletarians of all countries, unite!” has long been dead, another leftist slogan “Tinkerers of all strands of economic thinking, unite in negating the successes of the market!” is still alive and kicking. Incidentally, after 2008 it has been kicking ever more strongly.

China and India’s performance is mostly (if not completely) the result of the relaxation of the rigid planning regime and the introduction of a substantial range of the market rules. Whatever economic problems these countries suffer from are the legacy of communist and the pre-communist past in China, as well as the legacy of bureaucratic planning and peculiarities of earlier Indian history.

The modesty of some market-oriented measures and the very strong responses to these relatively weak incentives are also tied to most recent and an older past of these countries. China at the end of Mao Zedong’s rule was an economic disaster, a country almost as poor as it was a few hundred years earlier. And the disaster occurred at the time, when other countries belonging to Sinic

³⁹ See Gaidar, *Anomalie*, 104.

culture around China raced forward, achieving ever greater prosperity. The GDP per capita ratio between, say, Taiwan and South Korea, and China (or India for that matter) was about 1:1 in 1950, but by 1990 it was 15:1 or more. The Deng Xiaoping market-oriented reforms injected a lot of vigor into Chinese society, but even after three decades of rapid economic growth, when China surpassed Japan as the number two world economy, Japanese GDP per capita was still ten times higher.

This is not a negative evaluation of the outstanding performance of the Chinese economy. And if reactions to introduced market stimuli were often surprisingly strong, it was again due to the impact of the communist legacy. The long suffering Chinese people in the country, where half-starved spiders preyed on half-starved flies—to use Samuel Johnson’s words in the different geopolitical context—jumped at the first opportunity to have a chance to produce food for themselves not for the kolkhoz collective, to eat some of it, to make some money with which they could buy the very basic necessities.

They did not need to wait for perfectly formulated property rights; these would come later, at a higher level of GDP per capita. That was simply the very beginning of feeling human, as the most horrible communist repressions had also eased at the time, when the cryptic formula: “It does not matter, whether the cat is white or black. It matters whether it is good at catching mice” was uttered from the very top. The enlightened despots—a dream of so many leftist intellectuals (including economists)—did not help much. On balance, the opposite might have been true. The prevailing thinking of communist leadership might have harmed the pattern of economic development.

The typical planner’s dream of growth through high level of investment did not die with the death of Mao Zedong. China moved from high (30%-plus) investment/GDP ratio under communism to an even higher one since mid-1980s, when the reform of the industrial sector began. Efficiency of such investment, whether in production or technical infrastructure, is very low.⁴⁰ The declining share of private consumption in GDP, when GDP accelerates, has been, since Simon Kuznets’s studies, a well-recognized phenomenon. However, the absolute decline in that share to below 40% is certainly a major distortion. The distortion in question had been helped by the largely state-owned financial sector in China that has been stacked against the small saver and favored large, usually state-owned investors.

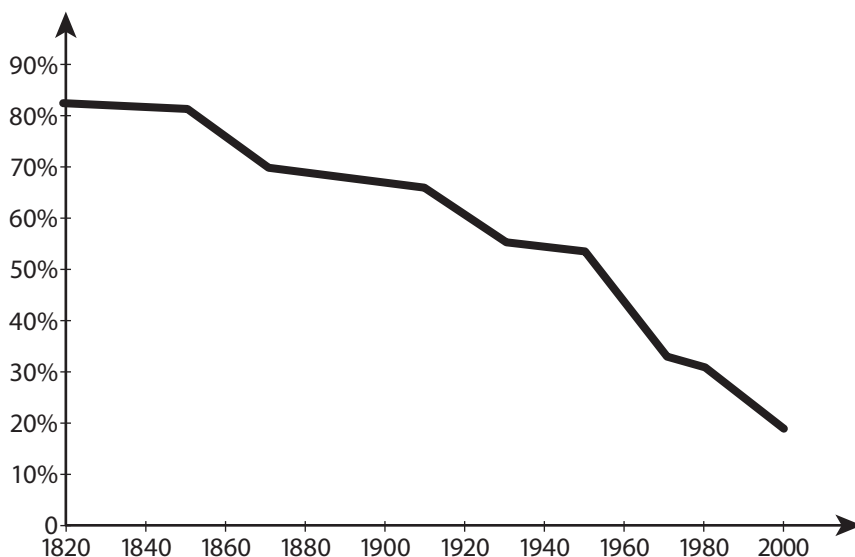
In the case of India there is no communist legacy, but the “kafkaesque”—to quote Jagdish Bhagwati—planning bureaucracy exercised a very strong pressure on the behavior of private sector owners. The latter, too, once the 1991 reform reduced that pressure considerably, seized the opportunities. Unfortunately, these opportunities were greater in new or emerging economic

⁴⁰ More on these issues in Jan Winiecki, “The BRIC Group—How Strong a Challenge to the West,” *World Economics Quarterly*, vol. 13 (2012), no. 2, 1–44.

activities than in traditional manufacturing production and municipal services. So the Indian economy has been growing fast, but with many distortions.

Nonetheless, the energy that the market injected into entrepreneurs, would-be entrepreneurs, and workers in both countries resulted in a major reduction of extreme poverty in these two most populous countries. Figure 3.4 presents the pattern of decline in extreme poverty, measured by income lower than \$1 per day, over the last two centuries throughout the world. There is no doubt that the 1820–2000 period was the period of the expansion of the institutional regime of the capitalist market economy; thus, the population of the globe owes its economic advancement, measured in terms of reduction of the extreme poverty from over 80% of the world population to about 20% today, to little else than market capitalism.

Figure 3.4. Changes in the share of poor people (living on less than \$1 a day) in world population, 1820–2000, in percent of the total⁴¹



And the argument questioning the existence of progress because it is only the extreme poverty that capitalism all but eliminated is invalid on many grounds. Two of them are formulated below:

- Firstly, no other economic system existing since the population of our globe settled to the overwhelmingly agricultural lifestyle did as much. Absolute poverty reigned all over the globe for some 8,000–10,000 years.

⁴¹ Source: Winiecki, *Economic Futures of the West* (based on Angus Maddison data).

- Secondly, other indicators (for example, of population living on \$2 or \$5 a day) also show continuous progress, especially in the last couple of decades, when benefits of rapid economic growth encompassed an ever larger set of countries beyond the West.

With such a unique set of achievements, let me raise a cautious two cheers for the developmental strategy based on the ideas close to classical economics, reinforced by the complementary strands of liberal, free market economic thinking. Why cautious and why only two, rather than customary three cheers? And why does the title of this chapter point to an incomplete success?

Certainly not because of the fact that it is about 80%, and not 100%, of the people that have been raised from extreme poverty. Regardless of what the “bloody do-gooders” of this world think and say (see Lord Bauer’s or William Easterly’s generalizations for the archetypal way of thinking of such people), progress is achieved over time. And the most recent period of the last 20–30 years has been a time of an accelerated progress.

Next, there is always the opportunity of snatching the defeat from the jaws of victory. Quite a few countries performed well, promised a lot, and then lapsed into a series of bad institutional and policy decisions—with very bad or even disastrous consequences. These and other cases of bad-to-very bad performance are not the outcomes of capitalist market-based developmental strategy, but either outcomes of alternative strategic choices or those of the already stressed lapses from the market path to stability and development.

My cautious approach stems also from two general considerations, one based on theory and another on most recent history of the West that threatens to project itself into the future. Cautiousness based on theorizing is the legacy of the *growth-of-knowledge* theory of Kuhn, (Michael) Polanyi, Hayek, and others.

Hayek looked at the accumulation of knowledge differently than overoptimistic thinkers of the nineteenth century. For them, he joked, the progress of knowledge amounted to the situation when there were two piles of bricks, one with bricks stamped “unknown” and the other stamped “known” and more and more bricks changed stamps and were shifted to the latter pile. With the solving of the last scientific puzzle all the bricks were stamped: “known” and shifted accordingly. All that was worth knowing became already known at that point in the future.

Hayek compared his way of looking at the generation of knowledge to the hiking in the mountains. As hiker moved up the hill he began seeing what was beyond the top of the hill (this was an equivalent of the bricks with the stamp: “unknown”). However, he also looked back and from his elevated position on the top of the hill he began to note that the landscape he left looks differently from above and requires a new description. Therefore, there is no end to the accumulation of knowledge.

To sum up the reflections on this cause of caution, we never know what is over the hill and may always wonder whether the institutions and policies that succeeded in the past are going to be sufficient to overcome challenges of the future. I assume that the logic of the market that builds up the resilience of entrepreneurial, innovative, well-incentivized individuals is going to cope better with future challenges than any other system based on rigid principles of planning, programming, etc., to say nothing about the amateurish, or worse totalitarian, search for a “new man” able to suffer selflessly in the name of future generations. But, as Hayek said repeatedly, the future is marked by radical uncertainty; so, cautiousness is understandable. The success of any strategy, even an empirically successful one, is inevitably incomplete.

My next major consideration is less concerned with the eternal problems of science and more with the—no less eternal, see Adam Smith’s thinking—imperfect nature of human beings. People are prone to temptations and tend to make the same type of mistakes again and again, damaging their own best-understood prospects. Remember the sad, reflective comment by Aaron Wildavsky: “We have seen the enemy and they are us”?

If my readings of the Western trends are right, societies in our part of the world are at the beginning of yet another attempt to search for the not so much better, but rather *more likable* economic system. If they were to succeed, consequences would be very large and negative—and not only economic consequences. We already live in a period of diminished growth prospects due to half a century of attempts to put too large a burden of the welfare state on the capitalist market economy.⁴²

If attempts to solve accumulating problems of the West through the application of measures hostile to the operation of markets succeed, we may say: “good bye” to the developmental prospects of Western economies. And not only to the economic prospects. Human history knows cases, where economic freedom, that is capitalist market with the private property and contractual freedom, existed without political freedom, that is, without liberal democracy. However, history knows no case, where political freedom existed for long, without the economic freedom as its underpinning. The three cheers are, then, not advisable.

⁴² See, again, Winiecki, *Economic Futures of the West*, Chapters 6–9.

Part II

TRANSFORMATIONS OF OUTPUT STRUCTURE IN THE PROCESS OF ECONOMIC DEVELOPMENT

Economies not only grow but also change their structure in the process of economic development. As their level of development, conventionally measured by GDP per capita, goes up, the supply side of the economy changes as well (the structure of output and employment in the first place). And although structural change accompanies the process of economic development in a continuous manner, it is worth identifying two specific phases, which bring about highly significant—quantitative and qualitative—transformations. For that very reason they are worth a thorough analysis.

The first of these two phases is better recognized, in terms of both theory and empirical verification, than the second. The first, that is industrialization, concerns changes in the structure of output, employment, foreign trade, etc., when industry, primarily manufacturing, takes over from agriculture the role of the driving force of the economy. Economics of development as a branch of classical economics and *development economics* as a separate body of thinking have studied changes in the structure of the economy as well as their determinants since World War II. Theoretical issues were debated even earlier. Decades of theorizing and empirical and policy research resulted in the emergence of a—more or less—coherent body of thinking.

The same, however, cannot be said about the second specific phase of structural transformation, that is, the shift in the role of the driving force from manufacturing to services, mostly to human capital-intensive private services. It is not only a much less researched phase of the economic development process, but also researched for a much shorter period. The research is additionally complicated by the fact that studies of the shift to services are intertwined with expressions of political alarmism, perceiving the shift in question not as a phase in continuing economic development process, but as a threat of deindustrialization facing the West.

Part II of this study deals in turn with each of these two specific phases. Chapter 4, concerning structural change and its determinants during the industri-

alization process, is more concise. After presenting the general pattern of sectoral structural change under industrialization and its variations, I tackled some weak points in the agreed body of thinking, established mostly in the 1950s–70s period. These considerations, although they do not undermine the general pattern and its variations, are nonetheless important in evaluating the performance and resultant outcomes of respective developmental strategies considered in Part I of this study.

The dominant characteristic of the state-centered strategy under the aegis of development economics theory has been its “shortcut” nature: the accomplishment of an accelerated or “forced” industrialization. An adoption of such a strategy resulted, however, in serious distortions in the performance of—too early established—manufacturing industries. With inadequate economic competence on the supply side of these economies, new firms in industries that were too sophisticated for a given level of development performed badly on both cost and quality counts. The foregoing resulted in the emergence of perennially uncompetitive industries and aggravated foreign trade problems, traditionally faced by less developed economies.

In Chapter 4, I underlined the similarity of the “steep ascent” strategy of communist command economies with the strategy pursued by most LDCs. Both aimed at accelerated industrialization and, therefore, both displayed the same “shortcut” characteristic. However, as stressed in Part I, the extent of distortions was much greater in communist economies.

Once industrialization has been accomplished, or at least advanced to the point that the share of manufacturing industries peaked at some 30–40% share in GDP, these by then already middle income economies approach the second specific phase of structural transformation. The share of services (to be more precise: market services, excluding public sector services) begins to increase significantly, usually at the cost of the manufacturing’s share. The dynamics, determinants, and enabling conditions of the shift to services are considered in Chapter 5.

The chapter starts with the acknowledgment of the existence of an intellectually interfering factor, namely the fear of deindustrialization. However, statistics of the share of manufacturing in GDP reveal markedly different shares of countries at very similar development levels, pointing at the existence of another determinant of sectoral changes than the deindustrialization phenomenon. I define it as the declining ability of *some* Western developed economies to compete in their own internal and international markets. Other patterns presented in the chapter add credibility to this diagnosis.

Given the relative newness of the experience of a rising share of market services and declining one of manufacturing, as well as difficulties with establishing determinants of that change, much of what is presented in Chapter 5 is based on a limited amount of empirical material. What emerges from the effort, however, is a message that service sector expansion is driven by a wider range of economic determinants and enabling factors than manufacturing expansion considered in Chapter 4.

Empirical studies prove that the level of fixed, tangible investment generating output growth relative to GDP is approximately the same in market services as in manufacturing, but the composition of that investment is different. In market services a greater share of tangible investment is registered by ICT (information and communication technology) and non-residential construction.

What differentiates, however, the expansion of output in market services, in comparison with that of manufacturing, is the—not yet uniformly calculated—*intangible* investment. It is a much wider range of activities than the R&D expenditures recently included into the national accounts. That range begins with computerized information, then stretches to a wide variety of innovative property and closes with economic competencies, mostly at the level of a firm. From a (limited) range of empirical country studies, it transpires also that investment in intangible capital displays two important characteristics. Its share grows over time in percentage of GDP, and the share is larger when the level of economic development of a given country is higher. In the US that share increased over 30 years to 13.9% GDP in the 1995–2003 period (exceeding slightly the share of tangible capital).

The evidence that the share of services in GDP grows with the level of development and is accompanied by a growing share of intangible investment sends an important developmental message. The message is that the economic development process during the second major structural transformation poses new challenges to middle developed/middle income economies entering that phase. In their case new sources of economic growth are required as the traditional drivers of industrialization lose their ability to generate further productivity growth.

Thus, it is not only the question of the economy keeping a proper level of aggregate fixed (tangible) investment, but also that of nurturing a larger—and growing—role of much varied intangible investment in order to maintain dynamic economic growth. These countries have to continuously change the supply side of their economies in the direction of an increasingly greater offer of such investments. Of course, what was written above about continuous change applies also to the already developed economies, where proportions between sectors continue to change and the range of human capital-intensive services within sectors (primarily the market services' sector) tend to diversify and expand. All these issues are considered in Chapter 5.

A bridge between the first and the second specific phases of major structural transformation has been built toward the end of the chapter under consideration. The importance of economic freedom as a determinant of growth, albeit confirmed by various correlations across a very large number of countries at different GDP per capita levels, has been questioned of late. Francis Fukuyama stressed the existence of a large number of fast growing countries with questionable levels of economic freedom and formulated the thesis that economic freedom need not be very good to generate high economic growth. It is sufficient that it is “good enough.”

In the last section of Chapter 5, I limit the validity of Fukuyama's thesis to the first transformation only. In the second transformation to human capital-intensive services, with its corollary of a wide range of intangible investment activities, the importance of institutional quality as an enabling factor, encompassing both economic and civic (including political) freedoms, increases significantly. I point to a number of empirical studies that strengthen my argument. Moreover, they also underpin the serious problems that middle developed economies are going to face if they do not markedly improve the quality of their institutions...

CHAPTER 4

Industrialization: The First Major Phase of Structural Transformation

Introductory Remarks on the Industrialization Literature and Structural Change

As noted in the introduction to Part II, structural changes in output, employment, etc., have been taking place throughout the whole development process. And, inevitably, they are going to continue in the future. Changes have been taking place at the level of major sectors, in industries within sectors, as well as across product groups within industries. What I am trying to do in this chapter is to look at the patterns of structural change that take place during the *industrialization* phase. With the understanding that such changes have been taking place both earlier, before the start of industrialization, and later—after that process has been, by and large, completed, at least in terms of the share of manufacturing in GDP.

Simon Kuznets,¹ a Nobel Prize winner, discovered in his studies that developed market economies of the West registered highly similar economic structures (in terms of output, employment, etc.) in the process of development. And the foregoing similarity was achieved in spite of the fact that industrialization had been taking place in these countries in different periods and with different speeds. He noted simultaneously that countries in the preindustrial phase—with agriculture as their dominant sector—also displayed among themselves similar structural characteristics.

These early observations by Kuznets gave an impulse to the studies of structural change in all economies, not only in developed economies of the West. The scholarly, theoretically justified, curiosity was, however, strongly reinforced by interests of the policy makers. For issues of the industrialization of less devel-

¹ See, in particular, Simon Kuznets, *Modern Economic Growth: Rate, Structure, and Spread* (New Haven, CT: Yale University Press, 1966) and *Economic Growth of Nations: Total Output and Production Structure* (Cambridge, MA: The Belknap Press of Harvard University, 1971); as well as a series of articles published over the years in *Economic Development and Cultural Change* in the 1950s and early 1960s.

oped (developing, “third world,” you name it) countries were at the center of both intellectual and political debate in the post-World War II world (see also above, Part I, Chapter 2).

As a consequence, observations by Kuznets in the late 1950s and early 1960s were taken as a starting point by a group of economists led by and cooperating with Hollis B. Chenery. The most often quoted names in joint publications are those of Moises Syrquin, Lance Taylor, Tsunehiko Watanabe, and Larry Westphal, but there were others as well.

These economists collected a wide range of data concerning various aspects of that part of the economic development process that has been traditionally called industrialization, that is, the shift in the production structure from the agriculture-driven economy to that of the industry, primarily manufacturing-driven one. The data were, then, used in the applications of numerous models and in econometric studies. A large number of publications appeared on the subject of industrialization, written by these authors. The corollary of that strand of research was the 1975 book by Chenery and Syrquin, *Patterns of Development, 1950–70*.

This series of studies was used, in turn, in innumerable discussions and in formulating policy prescriptions concerning the development process, mostly by the believers in *development economics*. The so-called development community was also influenced by the research in question and resultant conclusions.

To make a long story short, a general pattern of structural change concerning the changing share of manufacturing in GDP during industrialization emerged, using my own terminology, from the impact of *structurally unifying variables*.² These variables are consumer demand (that ultimately determines also investment demand, at least in countries where consumer sovereignty is not much trampled upon), technological change (that, jointly with final demand, determines intermediate demand), and foreign demand. These unifying variables tend also to reflect an attained level of economic development, roughly represented by GDP per capita.

The studies in question registered also deviations from the general pattern. In the Chenery and Syrquin book, the authors empirically established the existence of two *structurally differentiating variables*. They were:

1. The size of the national economy; and
2. The mineral resources of the country.

In fact, yet another variable was mentioned in their book, namely economic policies (a variable I would myself call institutions and policies pursued within these rules of economic game). Yet, for very specific reasons, that variable had not been put to empirical tests and no generalizations with respect to that variable were

² See Winiecki, *The Distorted World*, Chapter 3.

formulated in their book. I shall return to the neglectful treatment of this last differentiating variable somewhat later in this chapter.

Returning to the impact of unifying variables, the most important part of structural change during industrialization has been an increase in the share of industry, primarily manufacturing, in terms of output, as well as employment. Empirical studies established that manufacturing grew from, roughly, 10% of GDP at the start of industrialization to usually between 30% and 40% GDP (but often less for mineral resource-rich economies).

Since the large majority of the studies in question by these authors were published in the 1960s and 1970s, this generalization did not extend to the stage of industrialization, when the share of manufacturing begins to decline. For only a few of Western developed market economies began registering such declines at the time.

Thus, in the 1970s, the existence of the inflection point, i.e., the level of development (measured by GDP per capita), at which the share of manufacturing begins to decline—after reaching the peak share (the historical range of 30–40% GDP)—had not yet been recognized. In other words, the *curvilinear* nature of the manufacturing's share in GDP in the economic development process was not perceived as a part of the pattern.

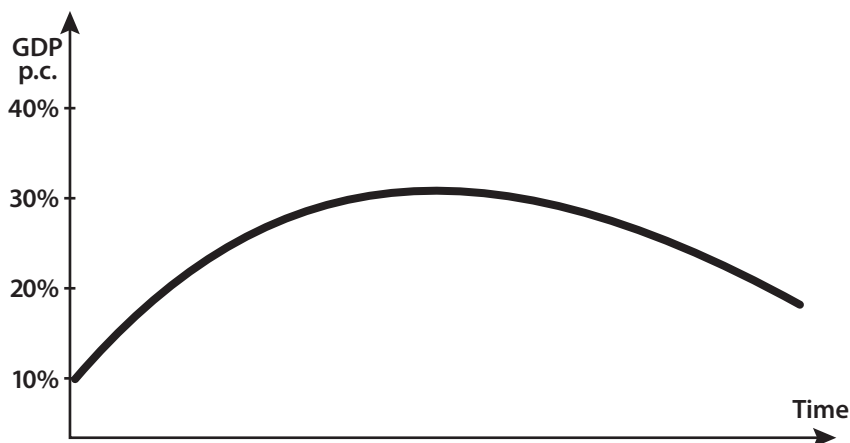
Later research established that the share of manufacturing, indeed, reaches such a point and begins to decline, while volume of output continues to increase. Some later studies set the inflection point at the lower share of manufacturing in GDP: at about 30% GDP or even less. The principle of the peak share held, though. However, attempts to integrate the curvilinearity into the patterns of structural change were additionally complicated by the oft-expressed alarms that the decline in the share in question was primarily a sign of declining industrial might (deindustrialization).

Patterns of Structural Change during the Industrialization Phase

Structural regularities in the industrialization phase established by Chenery and his collaborators in a number of studies begin with the most general pattern, concerning the changing share of manufacturing in GDP (and a very similar pattern concerning the share of manufacturing employment in aggregate employment in the national economy). It is an “ideal type” structural change of sort, based on the impact of the foregoing unifying variables on the changes in GDP per capita. The ideal type regularity with respect to output is presented in Figure 4.1. For space-saving reasons I present there also the—later established—“other half” of the curve, presenting the declining share (that is the one indicating the existence of curvilinearity of the manufacturing share).

In real life there are, inevitably, variations from the ideal type. The empirically observable differences resulted from the impact of two differentiating variables: size of the economy and the availability of mineral resources. As a first step,

Figure 4.1. Stylized pattern of change in the share of manufacturing in GDP per capita in the process of economic development



Chenery, Syrquin and others proved the existence of such variations from the ideal type resulting from the size of the national economy. Large countries registered a somewhat different pattern of change in the share of manufacturing in GDP. It might be added, however, that proper classification should describe this category as “large and middle-sized” countries because they included there countries with the population above 15 million people.

The curve representing the share of manufacturing in these countries’ GDP was steeper in the early period of industrialization. Being reasonably large, these economies were characterized by the existence of the internal market sizable enough to justify an earlier establishment of scale economy-based heavy, capital-intensive industries even at the very low level of GDP per capita. India offers an excellent example. The first steel mill was built in India at the turn of the twentieth century. Characteristically, it was a privately-owned mill, profitably operating decades before India chose the developmental strategy based upon the management of the economy from the center, preference for state ownership in “priority” industries, and underpinned this type of management with Soviet-style planning.

The case of a steel mill was just one example. The same early establishment applies in the case of larger countries to other scale-based industries: cement industry, bulk chemicals industry, etc. An interesting feature of this differentiation was the fact that large and middle-sized countries did not exceed the 30–40% share of manufacturing in GDP. In this respect they conformed to the ideal type. The difference was in the shape of the trajectory. Their share simply grew faster at the early period of industrialization due to the broader range of industries established in that period.

Smaller countries differed from the large and middle-sized ones with respect to the trajectory of the share of manufacturing, dependent on changing level of GDP per capita, and, significantly, differed also among themselves. The differentiating variable has been primarily the availability of substantial reserves of mineral resources (fuels and/or industrial minerals). In the research of the Chenery-inspired group of analysts, small countries were classified into two sub-categories:

- A more numerous group was that of small countries by and large poorly endowed with mineral resources and, therefore, more pressed to faster expand manufacturing industries; and
- A less numerous one, consisting of small countries richly endowed with mineral resources.

The former countries, given their limited domestic market and nonexistent opportunity to export minerals, were prodded to expand manufacturing industries early. The expansion in question was not only a part of the spontaneous economic development process (or, alternatively, of the state-centered, forced industrialization), but also an effort to satisfy a certain level of import demand of the national economy. Usually, exports of agricultural products very quickly turned out to be insufficient as a supplier of foreign exchange, while demand for it was growing quite rapidly with industrialization and an associated increase in GDP per capita. However, the success in such a role of manufacturing as foreign exchange earner depended on certain institutional and policy changes (see below).

Obviously, since these small countries were at early stages of economic development they should have concentrated their industrializing efforts on the establishment of firms, and consequently industries, using intensively inputs of unskilled labor. In other words, their industrial and export efforts should conform with the classical trade theory in the Heckscher–Ohlin version; the only plentiful production factor they possessed was unskilled labor.

Unfortunately, after World War II relatively few small countries, poorly endowed with mineral resources, opted for such strategy in its classical form. A large majority of less developed countries, which pursued an import substitution-based developmental strategy, shifted rapidly from manufacturing industries belonging to early stage of industrialization to those industries characteristic for middle stage industrialization. These efforts were very costly and, moreover, did not succeed in the establishment of a successful manufacturing export base (more on this below and also in Chapter 2 above).

The trajectory of change in the share of manufacturing in GDP for that group of countries differed from that trajectory for large and middle-sized countries. In the manufacturing-oriented small countries, the share of manufacturing sector at the early period of industrialization was lower than in larger coun-

tries. In that period it was mostly the expansion of the first, emerging branches of industry based on primary processing of the available natural resources.

Next, once industrialization accelerated, the engine role was taken over by industries that in the economics of development language were called *easy import substitution* industries. The production of furniture, as an extension of wood industry, of footwear as an extension of leather industry, of clothing as an obvious next step after textile industry, of glass industry emerging within the building materials industry—all to a greater or smaller extent expanded manufacturing output significantly.

In the institutionally successful countries, pursuing traditional comparative advantage-based approach, output of these industries increasingly became also an object of exportation. And these exports were competitive because factor proportions needed in the production of the easy substitution industries are roughly the same as in the industries that often begin to emerge in the pre-industrial phase. No steel mills, cement plants, etc., at this early period, as in the case of earlier considered larger countries!

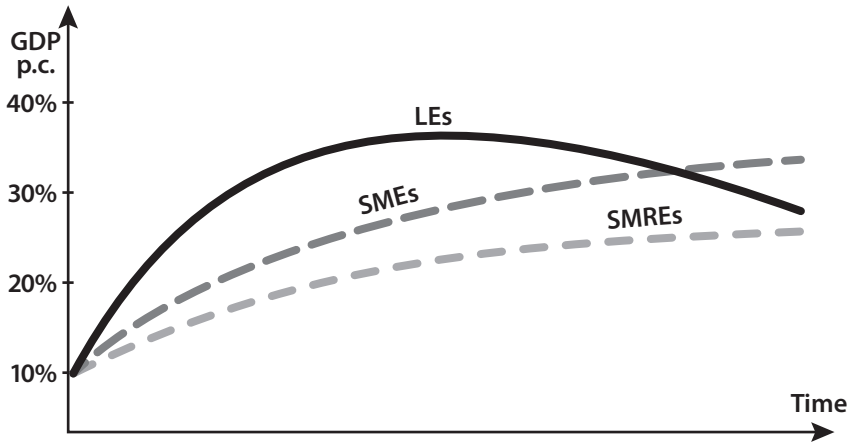
Generalizing on the experience, small countries pursuing their path of economic development move to establish other industries later—at that stage primarily capital-intensive ones. The challenges are much greater there because technologies are more sophisticated, the quantity of capital required is markedly higher, and the needed skill level of workers is also higher. Therefore, that stage of industrialization is called *difficult import substitution*. Countries moving to that middle period of the industrialization process establish a range of such capital-intensive industries (steel making, metal products, pulp and paper, rubber industry, consumer durables, etc.); some of them also scale economy-based ones.

It is in that period of industrialization that the share of manufacturing in GDP of small, manufacturing-oriented countries grows quite rapidly. The inflection point is usually achieved toward the end of that middle period. It is also at this stage that small manufacturing-oriented countries catch up with larger countries with respect to the share of manufacturing in GDP—and in some cases even exceed that share. Let us, next, compare this pattern of structural change in small, manufacturing oriented countries with the, again somewhat different, pattern of small, mineral resources-rich countries.

First, the latter countries, given the availability of mineral riches, do not feel a strong pressure to establish export-oriented, unskilled labor-intensive, manufacturing industries as foreign exchange earners. The necessary imports are paid from the receipts for mineral exports. As a result, structural transformation proceeds more slowly than in both larger countries and smaller, manufacturing-oriented ones. A share of manufacturing in GDP begins to grow at a later stage than in the earlier considered two country groups and does it more slowly. Graphically this contrast is shown in Figure 4.2.

The differentiating characteristics of small, mineral rich countries also have an impact on the sequencing of the established industries and their com-

Figure 4.2. Stylized pattern of change in the share of manufacturing in GDP per capita in large economies (LEs), small manufacturing-oriented economies (SMEs) and small mineral rich economies (SMREs) in the process of economic development.



position in terms of shares of respective industries, or industry groupings, in the manufacturing total. At a later stage, when manufacturing industries expand, the level of GDP per capita in these countries is already relatively high. At least higher than in the earlier considered two groups of countries. In consequence, their unskilled labor-intensive industries remain relatively small and, given the labor cost disadvantage, rarely attain a position of an exporter. Quite often, the industries that expand markedly are the ones based on the processing of the available mineral riches. More often than not they are capital-intensive industries. Altogether, they may achieve their peak share of manufacturing (the inflection point) at a lower level than in both larger countries and small manufacturing-oriented ones.

Figure 4.2 presents all three differentiated trajectories of the share of manufacturing in GDP during the industrialization phase of economic development. The trajectories graphically reflect the fast early increase in the manufacturing share in larger economies, the catching-up of small, manufacturing-oriented economies at a later stage and the lagging performance in this respect of resource rich small countries and their often lower peak share of manufacturing in GDP. The “ideal type” structural pattern of a changing share of manufacturing in GDP presented in Figure 4.1 is, then, a composite of the more specific patterns of different country groups outlined above.

Just as a reminder, it is worth stressing the following. In all countries—pre-industrial, those in the early or middle stage of industrialization, or those that have already completed the industrialization phase of economic develop-

ment—structural changes at various levels of aggregation take place *all the time*. Our concentration in this chapter on a specific, very important, phase of the development process stems from our interest in the structural characteristics of that phase.

Next, I would like to inquire into the third—so far omitted—differentiating variable. Namely, I would like to look into institutions and policies pursued within those rules of the game and their impact on the development process. In particular an inquiry should concern their impact on structural change that is of special interest in this study.

What needs to be restated first, it is the economic philosophy of the group of analysts whose studies and their generalizations I tried to present concisely in this section. All the analysts referred to so far (excluding Kuznets) were fervent believers in the strong guiding hand of the state in economic development. That strand of economic thinking has been known as *development economics*. It has already been presented in Chapter 2 above.

In the most often quoted research product of this group of analysts, that is the Chenery and Syrquin's *Patterns of Development*, one finds no traces, however, of any empirical regularities that would reflect the impact of one or another developmental strategy (more interventionist or more free market-oriented). One might expect such strategy differences to be reflected in the outcomes—also with respect to output, employment and other structural characteristics (export performance, for example).

I see two types of the explanation of a, rather surprising, neglect of institutional differences. The first, ideological, stems from the economic philosophy of the authors in question. They were convinced that the initiation of the industrialization process is well nigh impossible without the state taking the reins of the process, establishing the development bureaucracy, banks, and funds financing “priority” development projects, etc. Also they believed that industrialization begins, when large factories turn out large volumes of output.

In consequence, since kick-starting the industrialization phase of economic development was impossible—in their opinion—without a heavy dose of state intervention, they assumed that all countries start industrialization in the same manner. So they did not feel the need to differentiate them along the lines of different developmental strategies. The second type of the explanation is empirical. They thought they could neglect the above differentiation, since (especially in the earlier post-WWII period) there were so few cases of an alternative, more market-reliant strategy.

Both types of explanation fail—in my opinion—to convincingly justify the neglect of the question. First, even if there were few cases of an alternative strategy, their outstanding performance merited consideration (like the East Asian little dragons, see Chapter 3 above). And, second, even within the large group of less developed countries that imposed a heavy dose of state-centered strategy upon their economies there have been significant differences in the size of that

dose. There was, for example a difference between the very heavy dose in the case of, say, India and somewhat lighter dose in the case of Brazil. Such differences merited attention because in the period covered in Chenery and Syrquin's book they registered in the 1960s per capita GDP growth of 3.2% in the case of Brazil and meager 1.3% in India. And in 1950s the differential was also quite large.

The issue should have been all the more important as these strategy differences had a substantial impact upon structural transformation during industrialization. A state-centered development strategy, which has been called an import substitution-based strategy, given its goal, that is the accelerated substitution of imports by domestic industrial production, generated serious distortions of various sorts.

It is that state-centered strategy that amplified the usual problems of poor countries in generating sufficient foreign exchange volume through exports to pay for the increasing needs for imports. A high protection for the manufacturing industries established under the import substitution-based strategy is generally harmful for export-oriented industries. The latter industries find themselves under the disadvantage in a number of ways.³ Periodic shortages of foreign exchange turn under the circumstances into chronic ones.

Some of the distortions also affected changes in the structure of production. It had been known already in the early 1970s, from the first major study by Ian Little, Tibor Scitovsky, and Maurice Scott⁴ that state-centered, inward oriented, import substitution-based strategies of less developed countries of the South introduced price distortions that resulted, i.a., in the overvaluation of inputs to production on the one hand, while protected markets pushed up prices of output in import-substituting industries.

As a consequence, actual shares of manufacturing in GDP were usually overestimated, sometimes quite heavily (see Table 2.1 in Chapter 2 above, based on estimates made in Little, Scitovsky, and Scott, *Industry and Trade*). Generalizing, again, on the above empirical investigations, with real shares of manufacturing being smaller by a fourth or a third in some countries, the range of 30–40% GDP as a peak share of manufacturing—established in the said literature—was clearly overstated.

Yet these authors never displayed an interest in making any corrections to the patterns they established in 1970s. As late as in 1989 Syrquin and Chenery⁵ introduced for the first (and I assume last) time the somewhat twisted typologies of “inward-oriented economies” and, puzzlingly, “industry-oriented economies,” with the latter changing again their name in empirical investigations to more sen-

³ See, for example, Krueger, *Trade and Employment*, Chapter 3.

⁴ Ian D. Little, Tibor Scitovsky, and Maurice Scott, *Industry and Trade in Some Developing Countries* (Paris: OECD, 1970).

⁵ Moshe Syrquin and Hollis Chenery, “Three decades of industrialization,” *World Bank Economic Review* (1989): 145–81.

sible “outward-oriented” ones. They even admitted that outward-oriented economies performed better in terms of productivity and exports performance, but it was as far as they were ready go. No serious explanation why this was the case, was ever found in the research done by the believers in *development economics*.

Amplifications and Corrections of the Standard Patterns Established in the Development Economics Literature: The Impact of Institutions

Distorted structural characteristics were not confined to the share of manufacturing under the import substitution-based, inward strategy of less developed countries, considered so far. I found the same type of structural distortions, but with the much amplified scale of distortions, in the now defunct communist economies. The findings were presented in the already quoted book of mine.⁶

There, I stressed that the differences in the share of output and employment in the seven studied European communist economies relative to the rest of the world were solely the result of institutional—here: economic system- and strategy-specific—characteristics. The other two differentiating variables usually considered in the literature (see the preceding section) played no role whatsoever.

From empirical investigations in Chapter 3 of my 1988 book it transpired that both the direction of differentiation (oversized share of industry in all countries) and the dynamics of differentiation (the growing difference in industry's share over time relative to the standard pattern from the sample of non-communist countries) were identical for all seven countries. There were no additional differences arising out of the fact that the Soviet Russia was a very large country, while the rest were middle-sized and small countries. Nor the availability of mineral resources played any role, in spite of the striking difference in this respect between Soviet Russia on the one hand and the remaining six countries on the other.

The uniformity of the direction and scale of differences among the now defunct European communist economies in terms of the share of industry in GDP and the difference between them and the rest of the world was presented in Figure 1.3 in Chapter 1. Note, however, that among the countries included into an empirical inquiry as the standard pattern of reference were many LDCs with the also distorted, oversized shares of manufacturing industry!

Worth considering here are the sources of the difference in the scale of structural distortions in question between LDCs pursuing import substitution-based inward strategy and communist countries, reflected in Figures 1.3 and 4.2. Both groups of countries opted for the same *type* of strategy, namely the “shortcut” strategy (see Part I above), or “forced draft” strategy of industrialization—to use the term of Everett Hagen. It means that in both *development economics*-based strategy and “steep ascent” strategy policy makers and their planners decided on early establishment and expansion of industries for which the

⁶ Winiecki, *The Distorted World*, Chapters 3 and 4.

respective economies did not yet possess the necessary *economic competence*.⁷ Without such competence these countries were able to produce planned goods, but could not produce them economically, that is with revenues exceeding costs under competitive conditions of the open economy.

The production under the semi-closed (LDCs) or closed economy conditions (communist countries) generated price distortions, resulting in the overvaluation of inputs to production relative to their value on international markets. Moreover, in LDCs, protected markets pushed up prices of outputs in these import-substituting industries. Higher costs of inputs, combined with the freedom to set prices on protected domestic market, artificially raised the share of manufacturing in GDP (see the preceding section). In communist countries, where prices were set by central planners, the latter factor did not play such a role, but other determinants sharply increased the scale of structural distortions relative to LDCs.

Communist style central planning raised the costs of production, relative to the international market level, through the system-specific—not only strategy-specific—features. For in communist countries, not only the developmental strategy, aiming as much as possible at self-sufficiency at the national level, but also the structure of incentives embedded in the system prodded state firms to aim at self-sufficiency at the enterprise level. With the very high degree of supply uncertainty under central planning, the best way to ensure the uninterrupted supply of inputs was to use intra-enterprise production of parts and components instead of relying on external suppliers (that is other state firms). Such intra-firm production of inputs raised enormously production costs.

But that was only a part of the story. Even after correcting for higher prices of inputs, the share of manufacturing was much higher than in non-communist economies at similar income levels because other characteristics of communist economies created incentives for higher volume of—otherwise useless—manufacturing production. Such production in Sovietological literature was often called “production for production’s sake,” with no (positive) contribution to the wellbeing of the population.

For example, the treatment of investment as a “free” good by state enterprises in a world without bankruptcy resulted in much higher investment growth than in capitalist market economies. As presented in the first section of Chapter 3 above (“Millsian ‘Conspiring Circumstances’ and a Gradual Intellectual Conversion”), developed market economies required on average 1% increase in gross fixed capital investment for 1% increase in GDP. But with continuing excess demand for “free” good (here: GFCI) communist economies required on average 2% increase in investment for 1% increase in country GDP.

⁷ On this point, see Jan Winiecki, “Industrialization and Economic Development (On difficulties and pitfalls in the process of ‘catching up’),” Viadrina-European University, Frankfurt an der Oder, 1999, mimeo.

The same systemically distorted incentives raised the ratio of input inventories to output relative to firms in capitalist market economies. Input inventories were another “free” good. They were kept high to avoid production stoppages due to the lack of parts and components; overall the ratio was in the range of 60–80% of GDP, more than twice as high as in the West. It is also worth noting, that deviations from the pattern of change in the share of manufacturing in GDP, established by the group of empirically oriented development economists around Hollis Chenery, were all in one direction. Thus, again, one may wonder whether the peak manufacturing/GDP ratio considered above in the first two sections of the present chapter did not require some downward correction.

Nor were the foregoing distortions the only ones. Other economists dealing with economic development-related issues stressed their disagreement with the ideas of *development economics* on early industrialization. The idea that economic development begins only, when state-centered developmental strategy is initiated and the establishment of new firms in new, “modern” branches of industry rapidly increases industrial output was perceived to be erroneous.

In each edition of his textbook, Everett E. Hagen argued that industrialization begins differently.⁸ At the beginning it is a series of very small steps. He gives examples of such activities:

- milling wheat (rice) into flour in a machine-run mill;
- making crystallized, refined sugar;
- production of beer in a regular brewery with the classical technology;
- mechanization of spinning and weaving;
- making of clothing with the use of sewing machines;
- producing shoes made to standardized, graduated sizes;
- sawing of logs with the use of diesel engine-run saws;
- making standardized bricks and tiles in a kiln.

Hagen calls the increasing number of such activities *the creeping over the threshold of industrialization*. The growing number of such workshops or small factories up to a point does not need a large network of suppliers. The maintenance costs of equipment are also minimal. The threshold of industrialization is crossed and the emergence of what Hagen called “rudimentary industrial complex” becomes the reality, when a number of all these small entrepreneurs begins to multiply and opportunity for new business activities emerge.

Examples abound. A number of workshops and factories may produce different final goods, but may use similar inputs. If their number grows, then at a certain point an opportunity may emerge to build a factory to supply the inputs in question for the producers of final goods. Or, a market for industrial services

⁸ Everett E. Hagen, *The Economics of Development*, 4th ed. (Homewood, IL: Irwin, 1986).

may emerge. Maintenance and repair of machinery also create work opportunities in welding, forging, and machining. As demand for such services grows, workshops specializing in such activities create the basis for future establishment and expansion of metal products industry.

Thus, standardized industrial production begins at a quite early level of economic development. Interestingly, the patterns of structural change established empirically by Hollis B. Chenery and his collaborators do not contradict Hagen's thesis. Please, note that in their studies they usually set the beginning share of manufacturing at the start of the industrialization process at about 10% GDP. Obviously, that 10% level must have been reached earlier.

Such change has, however, further important implications. Industrialization begins earlier and such a conclusion requires from those studying economic development, with the accompanying structural change, to look back years and decades in the search for intensive economic growth, understood as slower or (more rarely) faster, but sustained GDP p. c. growth. Furthermore, there is a serious complicating factor involved, namely a very much weaker statistical base.

Nonetheless some attempts had been made to look at the early intensive economic growth. Lloyd G. Reynolds, a student of Hagen, established the existence of slow, but sustained economic growth on per capita basis over long periods and for a quite large number of non-Western countries.⁹ Usually, intensive growth begins, when institutional conditions improved: a reasonably stable government has been established, basic legal framework created, decent level of the protection of property rights applied in administrative and judicial practice. Reynolds notes that not infrequently such conditions emerged only after the establishment of colonial administration!

The chronology of early economic growth per capita, combined with the beginnings of industrial development along the lines earlier stressed by Everett Hagen, is also interesting. Twenty-three less developed countries of the South initiated their intensive economic development between 1840s and the outbreak of the World War I. Chile was the first in 1840s, followed by Malaysia, Thailand, and Argentina in 1850s and 1860s, with Korea joining the club in 1910.

Economic growth faces the best conditions in an open international economy. Reynolds established that the initiation of intensive growth often followed the sharp increase in commodity exports. A rise in incomes broadened, so did the market for manufactures. As a consequence handicraft products and imported manufactures were gradually complemented (and often superseded) by locally established workshops and factories, along the lines of Hagen propositions presented above. Such incentives from the world markets were much rarer in the

⁹ See Lloyd G. Reynolds, *Economic Growth in the Third World* (New Haven, CT: Yale University Press, 1986); and *ibid.*, "Government and Economic Growth," in *From Classical Economics to Development Economics*, ed. Gerald M. Meier (New York: St. Martin's Press, 1994), 226–41.

period of the two world wars and the great depression of 1930s. Unsurprisingly, then, only three LDCs joined the club of economies experiencing the GDP per capita growth (Morocco, Venezuela, and Zambia in 1920s).

The appearance of Zambia reminds us about other future disaster stories from Africa. For Zambia was not the first such intensively growing economy. Intensive economic growth was registered already in 1890s in Nigeria, Ghana, Kenya, and the Ivory Coast.

Let us return to generalizations on the patterns of structural change in the industrialization phase. What has been presented above, that is, evidence of the early emergence of a manufacturing sector in the less developed countries of the South, is not—as I pointed out—undermining the empirically established patterns of structural change presented in this chapter. It is, however, undermining the basic tenet of *development economics* that the initiation and expansion of industrialization requires state-centered developmental strategy and strong controls over the economy.

It is worth stressing that the intensive economic growth, combined with the slow expansion of the manufacturing sector, took place in the South until World War I within the framework of the private ownership-based capitalist market economy. Such outcome is not only a theoretically valid and empirically verified alternative to extensive interventionism superimposed upon the market, but it proved itself a more efficient alternative. Ghana is an interesting case in point. An intensive per capita growth started there already in 1890s and the post-independence rule of Nkrumah and his successors turned a promising case of growth into an unmitigated disaster (see a brief outline of post-1957 Ghana in Part I, Chapter 2 above). Zambia is another disaster story of the same sort.

Good Institutions: A Closer Look at Economic Freedom

I did not delve deeper into the issue of institutions (and policies pursued within the institutional rules of the game). I just suggested that good institutions help economic development in general and industrialization plus manufactured exports' expansion in particular. Classical economics, revived and refined over many decades, came back into fashion in late 1970s. That comeback was reinforced by the disappointing experience of both developmental strategies of communism and of *development economics*' activist philosophy, as well as the failure of Keynesian macroeconomics to cope with the stagflation in the 1970s (see the section on "Millsian 'Conspiring Circumstances' and a Gradual Intellectual Conversion" in Chapter 3 above).

Both classical economics (see Adam Smith's "system of natural liberty") and the historical experience of the West stress the importance of freedom, especially economic freedom, for economic wellbeing as an outcome of economic development. Reaching beyond the West, I underline in this study the role of economic freedom in the success of East Asian little dragons (see "Asian 'Little

Dragons': Unloved Children of Developmental Success" in Chapter 3 above). For there is no doubt that Hong Kong, Taiwan, South Korea, and Singapore owe largely their successes to greater economic freedom within the national economy, as well as greater freedom in economic interactions with the outside world. Many Southern countries tried at some point to emulate their strategies, with mixed effects (as shown in Part I, Chapters 2 and 3).

Here, however, the picture—from the vantage point of relationship between economic development and economic freedom—gets more complicated. A number of organizations prepare meticulously comprehensive rankings: *Economic Freedom of the World* by the Frazer Institute, *Index of Economic Freedom* by the Heritage Foundation and Wall Street Journal, *Doing Business* index by the World Bank—to name the most important systematic endeavors in this respect.

And these indices offer a somewhat confusing picture. Countries we know enjoy economic freedom (and at the same time they perform well in terms of economic growth) are, indeed, ranked highly. However, there are many countries that clearly do not enjoy much economic freedom and, yet, their economic performance has been admirable over long periods. For years, and sometimes even for a number of decades, they register high economic growth rates—in spite of their low rank in these indices.

Since the so-called BRIC group of countries is of special interest in this study, let me begin with the four countries of the group. Russia (139th) recorded the worst rank, with China barely ahead (136th), then India (119th), and the group's leader in terms of economic freedom, Brazil, was ranked barely 100th (data from 2013 *Index of Economic Freedom*). But the foregoing just opens the Pandora box for every doubting Thomas. There are also other good economic performers (that is high growth achievers) with a bloated standing on economic freedom. To begin with the worst offenders, we have Vietnam (140th), Nigeria (120th), Indonesia (108th), Azerbaijan (88th), and Saudi Arabia (80th), to name a few. There is, then, an intellectual dissonance between identifying economic freedom with good performance in the long run and the reality of the contemporary economy, where there are too many exceptions to that linkage.

Thus, at the low-to-middle levels of income the correlation with good institutions (understood here as high level of economic freedom) is relatively weak. It is this intellectual dissonance, I suspect, that prompted Francis Fukuyama to pronounce on the subject. In his recent book,¹⁰ he noted that in the contemporary economies, with their strong influence of technological-organizational changes, economic institutions need not be perfect (meaning: rank highly on economic freedom). It is sufficient that they are "good enough."

I tend to agree with Fukuyama, but with two important qualifications imposed on his "good enough" formula. The first is drawn from the shape of all

¹⁰ Francis Fukuyama, *The Origins of Political Order* (London: Profile Books, 2011).

correlation diagrams I know. Since they invariably show low-to-medium income (GDP p.c.) countries displaying lower correlation with economic freedom and high income countries displaying—by contrast—much higher correlation in this respect, I would limit the validity of Fukuyama's thesis only to the former, low-to-medium income countries. This point will be considered at greater length in the following chapter.

The second qualification would constrain the Fukuyama thesis even further. For I would posit that his "good enough" thesis became possible only in the modern world—not only dependent on sophisticated technologies and organizational arrangements, but also on the widespread use of the fossil fuels. I rely in my qualification on the highly perceptive evaluation by Deepak Lal.¹¹ In his book he referred to two types of economic growth: "Smithian" growth and "Promethean growth." The first is obvious: economic progress is dependent on the Smithian "system of natural liberty." The second refers to the well-known legend: humanity discovered the fossil fuels and put them to use in the process of economic development.

Let me use an example of communist economies to explain the importance of the existence of Promethean growth for the Fukuyama thesis. The institutional framework of the second communist economic system (centrally planned and administered economy) has been so antithetical to economic growth from the perspective of its structure of incentives that it would collapse under the weight of its incompetence as soon as the first communist economic system (so-called war communism in 1917–21). No Smithian growth would have a chance to occur at all! However, given the—abundant!—existence of fossil fuels, communist Russia survived, and even grew in various periods. It collapsed only after exhausting also the potential for Promethean growth, due to a number of specific developments.

From there stems the second qualification for the Fukuyama thesis. The thesis would have been completely wrong in the world in which there were opportunities only for Smithian growth. All these outliers mentioned above would not have enjoyed their economic growth without the simultaneous existence of not only Smithian, but also Promethean growth. They would have failed as conspicuously as did communist economies.

¹¹ Lal, *Unintended Consequences*, 1998.

The Shift to Human Capital-intensive Market Services: The Second Major Phase of Structural Transformation

Between Theorizing on Structural Transformation and Alarms on Destructive Deindustrialization

In the preceding chapter I presented my comments on what may be regarded as a reasonably well established pattern of structural change in the industrialization phase of economic development. I offered there modifications that were addressing some perceived weak spots in the theory and evidence but did not undermine the basic consensus on the subject. This, however, is not the case with respect to the set of issues addressing the second important phase of structural change. There is a lot of interesting, often thoughtful, speculation on the second major transformation—a shift in the economic growth's engine role from manufacturing industry to primarily human capital-intensive market services—but it is difficult to maintain that there is already an agreed body of thinking. Writing at the beginning of this century on changes in the structure of production, centered on the ever larger share of services, Ronald Schettkat and Lara Yocarini admit that a “full understanding of the factors accounting for the continuous shift to service industry employment is still lacking.”¹ In fact, the existence of theoretical underpinnings of such a shift is questioned in numerous writings, both academic and policy-oriented ones, analyzing the process that received the name of *deindustrialization*.²

Analysts thinking in terms of deindustrialization are, clearly, miles apart from those treating curvilinearity of the share of manufacturing industry as a part of the larger pattern of structural change. Rather, deindustrialization is seen, especially in policy-oriented studies, as a threat to the well-being of the developed Western economies.

¹ Ronald Schettkat and Lara Yocarini, “The Shift to Services; A Review of the Literature,” Forschungsinstitut für die Zukunft der Arbeit, Discussion Paper No. 964, Bonn, 2001.

² See, for example, Stephen Nickell, Stephen Redding, and Joanna Swaffield, “The Uneven Pace of Deindustrialization in the OECD,” London, Centre for Economic Performance, London School of Economics, May 2008.

Table 5.1 confirms the phenomenon of the shrinking share of manufacturing in GDP in developed Western economies; other calculations repeat the result with respect to manufacturing employment.³ The data presented in the table confirm, indeed, the pattern of decline in the share of manufactures in GDP. However, the statistical details on the subject pose as many questions as they generate answers.

Table 5.1. Changes in the share of manufacturing in GDP in selected West European developed economies in the years 1964–2010 (in %)⁴

	1964	1970	1980	1990	2000	2010
Smaller countries						
Austria	33.2	33.7	28.3	19.3	18.4	17.3
Belgium	31.1	32.1	24.5	18.2 ^a	17.1	12.5 ^b
Denmark	19.7 ^c	18.5	16.4	15.0	13.9	10.5
Finland	21.8	24.3	25.6	19.7	24.7	16.5
Netherlands	—	29.0	23.5	17.1	13.9	11.9
Switzerland	—	—	—	20.4	17.9	18.1
Sweden	27.7	25.0	21.7	16.0 ^d	19.3	14.2
Larger countries						
France	29.3	28.7	26.2	—	14.4	9.7 ^e
Germany	39.9	38.4	33.1	25.4	20.8	18.7
Italy	27.6	29.0	30.5	21.2	18.6	15.0
United Kingdom	30.0	28.1	22.1 ^f	20.3	14.7	10.2

Most importantly, they point to the different speed of change in the manufacturing industry's share of GDP. It is difficult to explain the structural regularity such as the curvilinear trajectory of manufacturing industry's share in output (and employment) if countries of the similar size and similar GDP per capita change the share in question at markedly different rates.

And yet this is precisely the case when one compares changes in the share of manufacturing for Germany on the one hand with those of France and the United Kingdom on the other. With Germany's share in 2010 at the level of 18.7% GDP and France and the United Kingdom shares at the level of 9.7% and 10.2% GDP respectively, approximately half of the German share, the specter of deindustrialization seems to be lurking behind the French and British numbers. Clearly,

³ See, e.g., *Service Industries and Economic Performance*, 1996.

⁴ Notes: a—1995; b—2009; c—1966; d—1993; e—2009; f—1979.

Sources: OECD, *National Accounts 1964–1981* (Paris, 1983); and OECD, *National Accounts at a Glance, 1989–2011* (complete database available via OECD's eLibrary).

there are other forces at work, beside those resulting in the structural shift in the growth engine's role from manufacturing to market services as countries' GDP per capita continues to increase. My suggestion is that different levels of international competitiveness interact with the determinants of the shift in question.

The calculations presented in Table 5.1 suggest that some countries lose in certain periods their international competitiveness and the losses in this respect are reflected in relatively faster decline in the share of manufacturing in GDP. However, with improved institutions and policies, they regained their mettle and competed better on their own and international markets, which is subsequently reflected in higher shares of manufacturing than in earlier periods.

Such has been the case, for example, of Sweden and Finland. Sweden was losing its competitiveness gradually over the period of the 1970s and 1980s, but after the severe crisis in early 1990s and competitiveness-enhancing institutional changes it improved its ability to compete as reflected in the increase in the share of manufacturing from 16.0% to 19.3% GDP in the year 2000. Finland's pattern was similar, but the period of weakness lasted only about a decade (over the 1990s), and by the year 2000 the share of its manufacturing amounted again to impressive 24.7% GDP, about as much as in the 1970s and 1980s. However—let it be noted—the cases of Sweden and Finland do not undermine the basic pattern of curvilinearity of manufacturing industry's share in GDP. For after improving their international competitiveness, both Sweden and Finland, registered in the subsequent decade a decline in their shares, although from a higher level.

A more general question should be asked as a next step in the inquiry. Namely, why the share of manufacturing in GDP after reaching a high point (between 30% and 40% GDP, see Chapter 4 above) begins to decline? To answer the question two explanatory variables need to be considered.

The first is the change in the structure of demand as the economy continues to grow and GDP per capita increases further. There is statistical support for the thesis that more affluent societies display relatively greater demand for services than for products, albeit the rationale for the shift toward services has been evolving over time. The second variable affecting demand for (manufactured) products is the competition in an open international economy. The next two sections of this chapter will be devoted to the impact of these two variables.

Determinants of Demand Shift to Market Services

The idea of structural change in terms of large sectoral shifts—from agriculture to industry to services—has a long pedigree. Among the “classics” of that approach one should refer to Colin Clark, whose ideas presented in the much-quoted book, *The Conditions of Economic Progress* (1940 and 1951), pointed to demand changes in the process of economic development. At a certain level of income (now we use the GDP per capita measure, not in use in Clark's time) demand for manufactures would be—by and large—satisfied and demand would, in his view,

increasingly shift to services. Allan Fisher expected the same shift to services and stressed the luxury character of some services as a factor augmenting the shift to services at higher income levels.⁵

Clark, as well as others, might have been influenced in their thinking on structural change also by their contemporary, Abraham Maslov, and the latter author's popular hierarchy of needs.⁶ In the hierarchy of needs those more basic, physiological needs that should be met first are associated with the use of products (food, clothing, shelter) and so-called free goods such as air and water (that are rarely cost-free!), while a number of higher-level safety needs are more associated with services (personal and property protection, health protection, etc.).

Jean Fourastie, more than Clark, stressed the productivity growth differential between manufacturing and services. In his view both greater demand for and lower productivity growth of services would strongly affect the changing proportions between the share of manufactures and services in employment.⁷ He explicitly envisaged as an outcome a rapid increase in employment in the service sector, the share of which in employment would exceed that in output.

The observations of Fourastie concerning slower productivity growth in services are a bridge to the opposite view, namely that there is no shift in demand in favor of services at all. Statistically registered output growth in services at current prices was, according to William Baumol, the byproduct of uniform wage increases coupled with highly differentiated productivity increases between manufacturing and services. Baumol, alone and with collaborators, produced a series of such studies, stressing the non-existence of demand determinants in the case of the growing share of services.⁸

I regard the revisionist Baumol's view as untenable in the face of mounting evidence of the growth of demand for market services, coming from both traditional and new sources. Thus, growing demand comes from traditional sources, associated with higher demand for services such as, for example, tourism at higher per capita incomes, but also from those associated with social change (demand for household services from married couples, where both partners are employed or self-employed) to those imposed by demographic changes (care-related services for the growing number of elderly people). Thus, I would support

⁵ Allan Fisher, *Clash of Progress and Security* (London: Macmillan, 1935).

⁶ Abraham Maslov, "A Theory of Human Motivation," *Psychological Review*, vol. 50 (1943), no. 4, 370–96; and Maslov, *Motivation and Personality* (New York: Harper, 1954).

⁷ Jean Fourastie, *Le Grand Espoir de XXe Siècle* (Paris: Presses Universitaires de France, 1949).

⁸ William J. Baumol, "Macroeconomics of Unbalanced Growth: The Anatomy of Urban Crisis," *American Economic Review*, vol. 57 (1965): 415–26; William J. Baumol, S. A. B. Blackman, and E. N. Wolff, *Productivity and American Leadership: A Long View* (Cambridge, MA: MIT Press, 1991); and William J. Baumol, "Paradox of Services; Exploding Costs, Persistent Demand," in *The Growth of Service Industries: The Paradox of Exploding Costs and Persistent Demand*, ed. Thijs ten Raa and Ronald Schettkat (Cheltenham: Edward Elgar, 2001), 3–28.

the growth of demand for services cum productivity differentials as an explanation of the expansion of the service sector. However, in addition to considering the demand side, I regard it worthwhile to consider the supply side determinants of the service sector's expansion.

For the latter's influence have been widely supported by evidence from economic history. The historical emergence of new sectors and industries within sectors is associated with the process of specialization. In the case of the first major phase of structural change, that is industrialization, it has long history.

It began in the Middle Ages, when able serfs began specializing in some crafts, serving their lords, as well as their neighbors. More entrepreneurial ones decided at one point to leave, legally or illegally, their lord and try their luck in a nearby or a more distant town, often starting their occupational career as apprentices with the town's craftsmen. Later, in the seventeenth and eighteenth centuries, the entrepreneurial newcomers, not belonging to, by then ossified, craft organizations, were among those starting independently their own manufacturing ventures. The tradition survived well into the twentieth century, when for example a certain village handyman decided to try his luck in the nearby Detroit to realize his idea of producing cars not in the craftsman's workshop, but on a mass production, factory scale—and, in consequence, at a drastically lower cost. And Henry Ford succeeded, indeed, to an unbelievable extent.

I see no reason to assume that the specialization process under consideration runs out of innovative ideas with the end of industrialization phase and with manufacturing sector beginning its gradual decrease in the share of GDP. The expansion of the market services' sector should offer no less attractive specialization opportunities. And, indeed, it does. There has been a lot of evidence of such a specialization process taking place. To begin with, entrepreneurial individuals have been leaving manufacturing firms and opening their own service firms or becoming self-employed specialists. They offered specialized services to their former employers and to other manufacturers.

Incidentally, at times, the same happens to whole firms, which shift from being primarily manufacturers, hardware producers, to becoming primarily service providers (more about that phenomenon in the next section of this chapter). At both individual employees' and firms' level this process is expected to continue. One caveat should be made at this point, though. This is not only an ongoing process, but also a never ending one. We should not expect that at some point there will be a complete separation of manufacturing and service activities within firms. They are going to continue as complementary activities, although differing in proportions, just as they did throughout the recent past.

More importantly, two general issues associated with the ascent of market services as the major driving force of the national economy in developed, high income countries, should be considered at this point. The first is the already expressed fear that the new engine will be running more slowly than that of manufacturing. Some studies noted the slowing economic growth rate from

one decade to another in developed Western economies. However, other studies pointed to the service sector's growth rates exceeding the GDP growth rates in most cases, as shown, e.g., in Table 5.2. Thus, a source of the slowdown must have come from other cause or causes. One of the culprits could be the already signaled deindustrialization.

Table 5.2. Average decadal growth rates of GDP and service sector in major Western economies in the 1961–90 period (in %) ⁹

	1961–70		1971–80		1981–90	
	GDP	Services	GDP	Services	GDP	Services
Canada	...	...	4.2	5.5	2.8	3.4
Germany	4.5	2.8	2.8	3.6	2.3	3.2
France	5.6	3.6	3.6	4.0	2.3	3.1
Italy	6.2	...	3.8	3.4	2.2	2.5
Japan	...	...	4.8	3.5	4.4	3.1
UK	2.8	...	1.8	2.2	2.5	3.6
USA	3.7	3.8	2.7	3.3	2.8	3.1

I shall return to deindustrialization, as promised, in the next section, but here I would like to remind readers that there is a growing body of research that points to a different culprit of the slowing economic growth in the West. It is the growing burden of public expenditures (particularly social expenditures, associated with the welfare state) as a share of newly created wealth, that is, GDP. Each prolonged period of higher public expenditures/GDP ratio results in a lower GDP growth rate in the next period.¹⁰ Other analysts add to the foregoing also over-regulation as another increasingly costly burden, slowing economic growth. Nonetheless, the growth slowdown explanations stressed above have an impact on the patterns of structural change that is of interest here only indirectly. It is signaled only as a reminder of other socio-economic determinants at work.

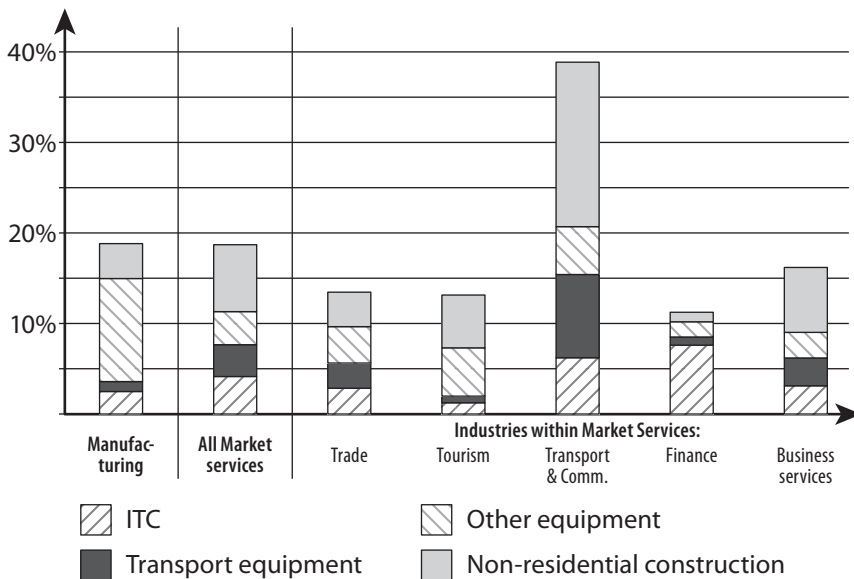
The second general issue concerns the service sector's internal dynamics. The idea that market services became the new engine of economic growth in high income capitalist market economies is not new. What may be regarded as novelty, however, is the conviction that the pattern of things to come—that is the second major phase of structural transformation—is being shaped primarily by *some* service sector industries. That is by those service industries that use intensively the production factor most abundant in high income economies, namely human capital.

⁹ Source: US Department of Commerce, Service Industries and Economic Performance, Washington, DC, March 1996.

¹⁰ See Winiecki, *Economic Futures of the West*, Chapters 6 and 9, and the literature quoted therein.

Human capital intensity is usually associated with other production factors, primarily physical (tangible) capital intensity. Empirical evidence suggests that the level of investment in tangible capital (or tangible assets) is not different in service sector from the level of investment in manufacturing (see Figure 5.1). Both stay in the range between 15% and 20% of the respective sectors value added in the European Union's case.

Figure 5.1. Fixed, tangible capital in % of value added in manufacturing and market services (plus industries within market services)¹¹



What is markedly different, however, is the composition of tangible capital. Almost two-thirds of tangible capital in manufacturing consists of machinery and equipment (even after excluding transport equipment). By contrast, in services—market services to be more precise—the dominant tangible capital consists primarily of non-residential construction and ICT capital (information and communication technology). Consequently, the shift of the growth engine role from manufacturing to market services does not suggest, then, the last- ing decline in the level of investment in tangible capital, but rather a change in its composition. However, certain measurement subtleties are involved in determining the role of human capital as a complement to tangible capital. A radically new approach emerged in the last dozen or so years in this area of

¹¹ Source: Uppenberg and Strauss, "Innovation and Productivity Growth," 20.

research. And, as it is often the case, radically new ideas are firmly grounded in the past.

More than 30 years ago, a Swedish economist, Bo Carlsson, published results of his research on the contribution of technical (product or process) innovation to productivity growth in Swedish manufacturing firms.¹² It transpired from his investigations that the contribution of technical innovation alone generated only between 20–30% and 60–70% of the achieved aggregate productivity growth. The reminder was the outcome of the organizational and other rearrangements of the existing production factors introduced on a continuous basis to better cope with technical change. Clearly, various intangible factors contributed substantially to aggregate productivity.

In fact, Carlsson based his idea of studying contributions to aggregate productivity on a yet earlier case, known in Swedish economic literature as “the Horndal effect.” A steel mill in Horndal was then increasing productivity by 2% *per annum* for 15 consecutive years without any new investment (except replacement of the physically used-up equipment). The continuous restructuring of all activities alone ensured improving productivity performance of the factory.

As signaled above, a group of empirically-oriented economists followed more recently the path pursued earlier by individual researchers like Bo Carlsson and came out with radically new schemes, systematizing and calculating what they called investment in *intangible capital* (or intangible assets). Moreover, in a series of country studies they—and other researchers following the same methodology—established that intangible capital is larger the higher the economic development level of a country is, as measured by GDP per capita. These issues and their economic consequences will be dealt with in the section on “The Intangible Capital” below.

For the moment, however, the return to the issue of competitiveness is in order here. For the absolute size of manufacturing in GDP and the rate of decline in its share are also affected by the competitive position of a country in the open international economy (it is, then, the other side of the coin called deindustrialization). The determinants and dynamics of that competition are, therefore, worth consideration, given their influence on structural change.

Commoditization of Manufactures and Changing Competitive Position of Developed Western Countries in the International Economy

It became fashionable to refer to “commoditization” when considering the international migration of production and changed pattern of trade flows. Kristian Uppenberg and Hubert Strauss used the term while explaining the shift in comparative advantages to less costly producers, like for example China. And they

¹² Bo Carlsson, “The Content of Productivity Growth in Swedish Manufacturing,” *Research Policy*, vol. 10 (1981), no. 4, 336–55.

give an example of “many manufactured goods, for instance consumer electronics, [that] have become commoditized.”¹³

The term may be new—and fashionable—but the phenomenon of changing comparative advantages goes back to David Hume and Adam Smith and the beginnings of classical economics. And the very term “commoditization” is an equivalent of another, earlier term coined by Raymond Vernon, who imaginatively combined in the 1960s–70s international trade theory and foreign direct investment theory.¹⁴

He explained how new products were being produced first in an innovative high income country, next, in other high income countries, and finally in low income countries. The driving force of the change in location of production has been the status of the technology invented originally by an innovative multinational firm. As it is first applied in production in the high income environment it offers very high profit margin to its owner, the multinational firm. However, over time, the technology is being mastered, then improved, and with such standardizing technology it becomes profitable to start manufacturing the product simultaneously in other high income countries (and, in effect, to sell more units of a product at lower prices).

As time passes, technology ages and becomes fully standardized. Such standardized, off-the-shelf technology is relatively easy to master even in the low skills/low income environment. At that point a given multinational firm may decide to shift production from high income country or countries to a new location in a low income country and start exporting the product from there to high income countries, taking advantage of much lower labor costs in the former country.

Thus the shift of production within a multinational firm results in the shift of comparative advantages across countries in the production of standardized, or in modern parlance, *commoditized* products, changing the pattern of international trade flows in the process. But it should be stressed that the process of shifting comparative advantages across countries has historically been taking place first in the so-called arm’s length trade—that is in the case of independent firms. The gradual shift in comparative advantages in the production and, next, exports of such, simple manufactured goods, based on lower labor costs, has been taking place for decades—and even centuries—in the international economy.

The process in question has been vividly described by Vasilis Panoutsopoulos.¹⁵ Describing the changing comparative advantages, he used the term

¹³ Kristian Uppenberg and Hubert Strauss, “Innovation and Productivity Growth in the EU Services Sector,” *European Investment Bank Papers*, vol. 15 (2010): 1–52.

¹⁴ See, in particular, Raymond Vernon, “International Investment and International Trade in the Product Cycle,” *Quarterly Journal of Economics*, vol. 80 (1966): 90–107; and “The Location of Economic Activity,” in *Economic Analysis and the Multinational Enterprise*, ed. J. H. Dunning (London, Allen and Unwin, 1974), 89–114.

¹⁵ Vasilis Panoutsopoulos, “The Growth of Exports from Developing Countries: Export Pessimism and Reality,” in *The Dangers of Export Pessimism: Developing Countries and*

“escalator movement.” Thus, applying his parable, fast growing top exporters moved up the escalator, producing and exporting not only greater volume and variety of certain exportable, unskilled labor-intensive products, but over time also new products of greater physical capital intensity and later still products characterized by human capital intensity (in the terminology used in this chapter, respectively tangible and intangible capital-intensive products). The upward movement on the escalator leaves room for newcomers at the lower rungs of the escalator. These rungs are, then, filled by firms from countries, where abundant, low skilled labor has been so far the only or main major advantage.

Although both explanations, those by Vernon and by Panoutsopoulos, present in new ways an old phenomenon of changing comparative advantages among countries, they at the same time—I suspect—are at the roots of the fear of deindustrialization. To continue with the Panoutsopoulos parable, what is going to happen when all countries move to the top rungs of the escalator? In such a crowded place pieces of the cake for those who arrived there earlier would shrink considerably, resulting in the much-feared deindustrialization.

That kind of fear could be allayed, however, by the addition of yet another escalator. Just as the Panoutsopoulos’ escalator applies to manufacturing production (and exports), the added escalator (call it Winiecki’s escalator) would apply to market services’ production (and wherever possible exports). Production of a wide range of services, often more in line with the achieved high income level and human capital abundance, would create new income and employment opportunities along the steps on the second escalator, reducing the reliance of a high income economy on traditional low skill and medium skill manufacturing.

Such an approach would accept the fact that high income countries lost competitiveness in producing and exporting commoditized manufactures and in consequence the “transformation of manufacturing firms into service providers (e.g., IBM or Ericsson) is a part of a shift in the comparative advantage of advanced economies.”¹⁶ A shift toward offering business solutions rather than producing hardware allows firms to move into the area of lower price elasticity—and higher profits.

But does it mean that we may dispense with deindustrialization altogether? The answer is “no.” My added escalator simply restores the balance between sectoral shifts in the process of economic development (from agriculture to manufacturing and, next, from manufacturing to services) and reintroduces the logic of competition, which does not end with manufacturing trade. There are still differences to explain between, say, Germany and France in terms of strikingly different shares of manufacturing in GDP in both countries (see above).

Industrial Markets, ed. H. Hughes (San Francisco, CA: ICS Press, 1992), 9–45.

¹⁶ Uppenberg and Strauss, “Innovation and Productivity Growth,” 15; as well as Kristian Uppenberg, “Economic Growth in the US and the EU: A Sectoral Decomposition,” *European Investment Bank Papers*, vol. 16 (2011), no. 1, 19–52.

However, explanations should not be couched anymore in terms of the general phenomenon of deindustrialization, but in more specific terms of a given country's (or countries') political and cultural climate, as well as resultant institutions and effects of pursued policies. Thus, the issue to explain is why *some* countries are doing worse than others in terms of their manufacturing share in GDP. All display the tendency of manufacturing share to decline after the economy passes the inflection point (the essence of curvilinearity), but the decline in that share may be faster and may go further in some countries for reasons specific to those countries alone.

The Intangible Capital: Measurement, Importance, and Association with the Level of Economic Development

The growing importance of services in terms of output and employment in high income economies turned attention to certain similarities and differences between the past engine of economic growth, that is manufacturing, and the emerging or already present engine, that is market services. Comparative studies among developed, high income economies reveal that, e.g., the level of fixed, or tangible, investment is not different in the service sector than in the manufacturing sector. In both sectors fixed, tangible investment is an important factor of productivity growth.¹⁷ However, there is a difference in composition of such investment between the two sectors in question.

About two thirds of fixed investment in manufacturing consists of "other machinery and equipment." Other means different from "ICT capital" (that is computers, communication equipment, and software) and from "transport equipment." By contrast, in services (market services, to be more precise) other machinery and equipment is the smallest component of fixed, tangible investment. In market services fixed investment, as well as asset composition, is dominated by non-residential construction and ICT capital.¹⁸

However, for an expanding market services' sector it is *intangible* capital that is of an even greater importance. Various recent studies stress that, for example, an investment in research and development contributes to the creation of productive capital stock, similar to that created by fixed, tangible capital. These studies point also to a wider range of investments in intangible capital that have so far been excluded from national economic accounts, primarily by measurement difficulties.¹⁹

¹⁷ See Uppenberg and Strauss, "Innovation and Productivity Growth."

¹⁸ Ibid., 17ff.

¹⁹ Bart van Ark, J. X. Hao, C. Corrado, and C. Hulten, "Measuring Intangible Capital and Its Contribution to Economic Growth in Europe," *European Investment Bank Papers*, vol. 14 (2009), no. 1, 62–93.

Such exclusion distorts—interested analysts say—the accounting for economic growth. “Outlays on software, R&D, advertizing, training, on organizational capital, etc. are critical investments that sustain a firm’s market presence in future years by reducing cost and rising profits beyond the current accounting period.”²⁰ The example of software for on-line banking which offered customers the opportunity to use banking services every hour of the day and every day of a week is a convincing piece of evidence. Evidence abounds also with respect to R&D, as well as to marketing intangibles: book value of conventionally calculated equity explains only a small fraction of firm’s market value (about 30%), but if capitalized value of marketing intangibles is calculated, then the ability to explain firm’s market value increases to 75%!

Thus, the main problem becomes the methodology of calculation. Official statistics are slow in accepting the changing realities, i.e., an increasing role of intangible investment. Computer software was included into national accounts after years of debate. Then came the 2013 correction, adding research and development to national accounts. But most of investments in intangible capital continue to remain outside national accounts.

And it is mostly the patient work of some analysts that adds much to our knowledge of the size and impact of investment in intangible assets. The works of C. Corrado, C. Hulten, and D. Sichel is of particular importance in this respect as most analysts followed their methodology in subsequent country and comparative studies.²¹

It is worth noting that these studies progressed much farther in presenting the methodology of calculation and systematic classification of intangibles than some ventures into specific areas of intangible investment, such as, e.g., the literature spawned by the book of Richard Caves on creative industries.²² The latter considerations deal with a much narrower and less methodologically analyzed area of intangible investment.

From the methodological and empirical Corrado–Hulten–Sichel (C–H–S) studies referred to earlier a number of important conclusions emerge. First, their results confirm the large contribution of “intangibles” to the productivity growth, implied already in the early study by Bo Carlsson on the impact of continuous adaptation of firm’s production factors to the introduced technical change (see “Determinants of Demand Shift to Market Services” above). Second, the share of intangible investment tends to grow with the level of economic development.

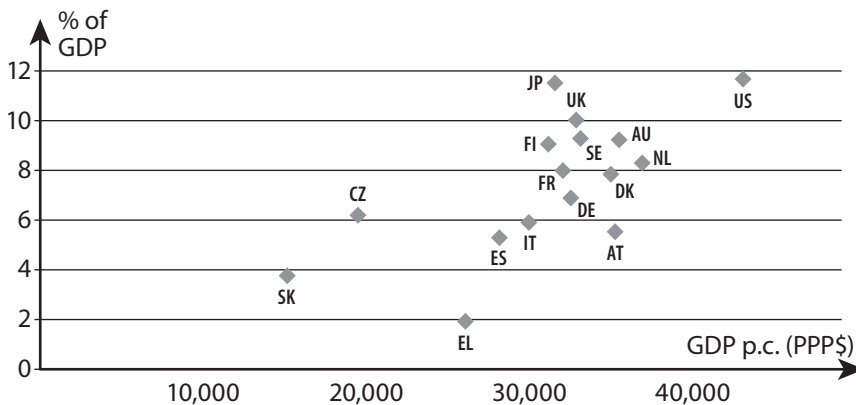
²⁰ Ibid., 65.

²¹ Carol Corrado, C. Hulten, and D. Sichel, “Measuring Capital and Technology: An Expanded Framework,” in *Measuring Capital in the New Economy*, ed. Carol Corrado, John Haltiwanger, and Daniel Sichel (Chicago, IL: University of Chicago Press, 2005), 11–45; and “Intangible Capital and US Economic Growth,” *The Review of Income and Wealth*, vol. 55 (2009), no. 3, 661–85.

²² Richard E. Caves, *Creative Industries: Contracts between Art and Commerce* (Cambridge, MA: Harvard University Press, 2000).

Empirical studies reveal a positive correlation between the size of such investment and GDP per capita (see Figure 5.2). And, third, the size of investment in intangibles approximates in the United States, the country among those with the highest GDP per capita, the size of investment in tangibles for the economy as a whole. Calculations along the lines of C–H–S methodology revealed that by the end of last century investment in intangible assets by US firms amounted to about 12% of GDP, similar to investment in tangible assets. Moreover, the former displayed the tendency to grow from 9.4% in 1973–95 to 13.9% in 1995–2003, while the latter registered over time a decline of similar magnitude.

Figure 5.2. Correlation between intangible investment and GDP per capita (for the years 2001–04) for selected high and middle income economies²³



The studies in question also added to our knowledge of the partly different sources of dynamism of the market services' sector in high income countries. To begin with innovation, the manufacturing prowess of firms depends overwhelmingly on product innovation and process innovation. This is not the case with the service sector firms, which rely to a significantly greater extent on marketing innovation and organizational innovation.²⁴

According to the accepted Corrado–Hulten–Sichel methodology, investment in intangible assets is classified in three large categories:

- Computerized information;
- Innovative property; and
- Economic competencies.

²³ Source: van Ark et al., "Measuring intangible capital," 80.

²⁴ Uppenberg and Strauss, "Innovation and Productivity Growth," 36ff.

Van Ark, Hao, Corrado, and Hulten's (2009) study presents both the aggregate level and proportions of intangible investment in each of the above categories and subcategories, for six large high income countries (see Table 5.3). As for the level of intangibles in terms of their share in GDP, the United States continues to be in the lead (11.48% GDP in 2006), with the United Kingdom close behind (10.54%) and then—at a distance—France, Germany, Spain, and Italy in that order (at a distance because the third country in the table, France, registers a share of 7.90% GDP).

Table 5.3. Intangible investment in the market sector of selected large national economies (in % of GDP in 2006)²⁵

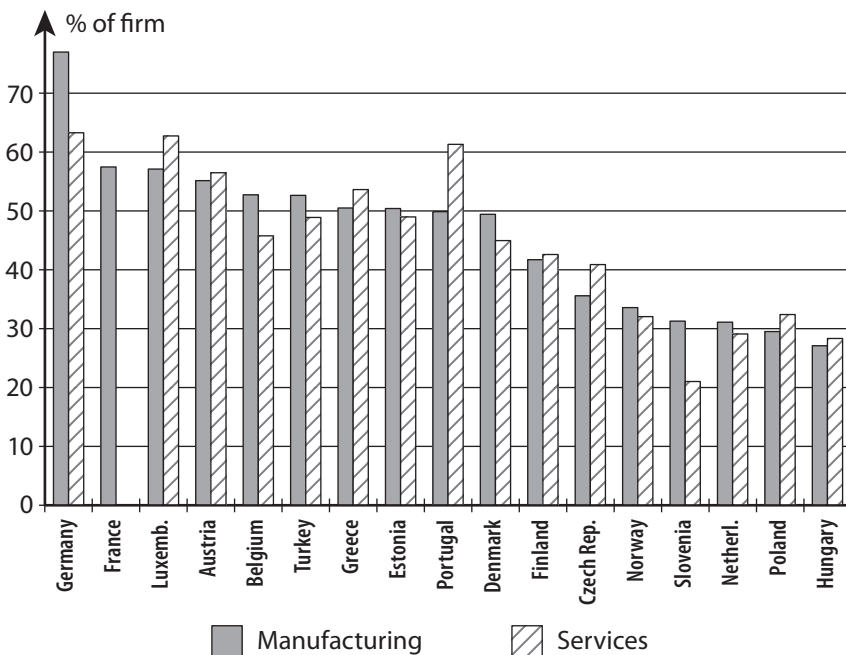
Type of intangible investment	Italy	Spain	Germany	France	UK	USA
1. Computerized information (software & databases)	0.64	0.79	0.73	1.42	1.55	1.61
2. Innovative property R&D incl. social science and humanities	2.21	2.78	3.59	3.18	3.16	4.37
Mineral exploration & evaluation	0.58	0.63	1.72	1.30	1.07	2.25 ^b
Costs of copyrights and license	0.09	0.04	0.01	0.04	0.04	
Development costs in finance industry	0.10	0.18	0.21	0.31	0.22	2.12 ^c
Architectural & engineering design	0.58	0.52	0.75	0.60	0.07	
	0.86	1.41	0.90	0.93	1.74	
3. Economic competencies ^a	2.19	1.90	2.84	3.30	5.84	5.50
Brand equity (advertising & market research)	0.71	0.42	0.56	0.99	1.15	1.47
Firm-specific human capital	1.02	0.81	1.29	1.51	2.54	4.03 ^d
Organizational capital	0.45	0.68	1.00	0.81	2.14	
Total	5.04	5.47	7.16	7.90	10.54	11.48

²⁵ Notes: *a*—60% of expenditures on advertisement, 80% of expenditures on own-account organizational structure, and 100% of all other expenditures should be considered as investment; *b*—R&D plus mineral exploration & evaluation; *c*—Copyright & license costs, development costs in financial industry, and architectural and engineering design; *d*—Firm specific human capital and organizational capital.
Source: van Ark et al., "Measuring intangible capital," 69.

Other studies stress the interaction between tangible investment in ICT capital and intangible investment in economic competencies, especially in firm-specific human capital and organizational capital. Given the general nature of the ICT capital (computers, communication equipment, and software), productivity gains arise over a longer time span, created by continuous adaptations of production factors to the invested ICT capital. Both now and long ago²⁶ “there is more to innovation—not least in services—than installing more and better machinery.”²⁷

Services are explicitly mentioned, given their much wider range of intangible investments and greater frequency of applying non-technological (marketing and organizational) innovations: 40% to over 60% of service firms reported such innovations²⁸ in high income countries, see Figure 5.3. On average, service firms’ innovations, more often than larger manufacturing firms, depend on external innovation, enhanced by the already stressed economic competencies within firms.

*Figure 5.3. Innovating firms in the area of marketing and organization (excluding technological, product and process, innovations) in manufacturing and market services in selected countries, 2004–06*²⁹



²⁶ See Carlsson, “The Content of Productivity Growth.”

²⁷ Uppenberg and Strauss, “Innovation and Productivity Growth,” 36.

²⁸ Ibid., 40.

²⁹ Source: Ibid.

The positive correlation between the level of investment in intangible capital and the level of GDP per capita, as in Figure 5.2, offers a number of important insights. Since high income countries generally register higher shares of market services in GDP and employment, intangible assets are strongly associated with the size of the service sector. The empirical country studies, analyzed in van Ark, Hao, Corrado, and Hulten's 2009 paper, concerning Greece, Slovakia, and the Czech Republic, offer estimates of investment in intangible capital of the size equal to 1.59%, 4.53%, and 6.45% GDP respectively. In all three countries the share of market services, especially human capital-intensive market services, has been distinctly lower than in the high income countries in Table 5.3. The distance is the smallest in the case of the Czech Republic, generally seen as being close to high income countries with respect to both purchasing power parity GDP per capita and structural characteristics of its national economy.

More importantly it suggests also the existence of barriers, or challenges, facing middle income economies if and when they approach the level of GDP per capita at which such human capital-intensive activities, creating intangible capital, increasingly begin to matter for continuing economic growth. One might add at this point that they also increasingly matter for associated structural change in the sense of a wide range of branches of services emerging in the economy.

Yet, in order to register growing demand for intangible capital, these economies need to reach a certain level of development, measured by GDP per capita, a level that is often called in the literature a middle income level. Why do I underline the role of the middle income level? Because low income, less developed economies may continue their economic growth, associated with industrialization, by shifting more unskilled labor from less productive agriculture to more productive manufacturing and reaping the benefits of that higher productivity in the latter sector. Also, firms in these economies buying and applying simple, standardized, off-the-shelf technologies or foreign multinationals making their export platform-type investments may contribute to continuing manufacturing output and productivity growth, with standardized ("commoditized") manufactures.

For both types of activities, traditional investment in tangible capital would be sufficient for a number of years to come. Thus, only after passing a certain threshold of income and acquiring certain level of economic sophistication (economic competencies), these middle income countries begin to face new requirements.

Such way of thinking finds support in the paper by Barry Eichengreen, Donghyun Park, and Kwanho Shin.³⁰ These authors studied periods of prolonged economic slowdown in a number of earlier fast growing economies since 1957. They came to the conclusion that such slowdowns happened most often, when these economies reached a particular GDP per capita level, namely almost

³⁰ Barry Eichengreen, Donghyun Park, and Kwanho Shin, "When Fast Growing Economies Slow Down: International Evidence and Implications for China," NBER Working Paper No. 16919, March 2011.

\$17,000 in 2005 international (PPP) prices, precisely, \$16,740 per capita, which undoubtedly is a middle income level.

What they did was to look for empirically observable, economic development-related determinants of prolonged slowdowns. These authors came to the conclusion that such slowdowns happened most often, when the process of shifting labor from agriculture to industry came to an end. There was, then, no more contribution to productivity increase from any further shift of workers to manufacturing industries, better equipped with tangible capital.

The foregoing applies to a greater extent with respect to capital-intensive manufacturing industries, dominant in the middle income level economies. They are the ones located in the middle rungs of the Panoutsopoulos first, manufacturing-related escalator (see the preceding section). Further movement to the upper rungs of the manufacturing sector escalator, as well as the entry on to the second, service sector-related escalator would both require new, more varied efforts.

Eichengreen, Park, and Shin's paper signals another source of the slowdown. It is the fact that the economy is getting closer to the technological frontier and further purchases and applications of standardized, off-the-shelf technologies generate diminishing returns. Strikingly worse outcomes appear especially with respect to the aggregate productivity: total factor productivity (TFP) growth declines to almost nil, from 3.04% to 0.09% annually. The foregoing aggregate productivity slowdown should be seen, however, as the combined impact of all barriers to further economic growth, not only that of decreasing returns to standardized technology.

A research and development story should be invoked at this point. Contrary to popular images, demand for R&D grows with the level of development of the economy, not the other way round. South Korea is an excellent example here. In 1970, half a decade after completing a major shift to a more market-oriented and more open economy (see Chapter 3, "Asian 'Little Dragons'" above), Korea, then a typical less-developed country, spent 0.39% GDP on R&D. Unsurprisingly, given the fact that those industries that usually spend significantly more than other on R&D were either minuscule or nonexistent in the Korean manufacturing sector. Approaching in the mid-1980s the middle income level, the Korean economy registered simultaneously an important structural change, especially in its manufacturing sector. This change was also reflected on the supply side in the increase in R&D to about 1.0% GDP.

Ten years later, in 1994, the level of R&D spending increased to 2.3% (accompanied by yet another change in the production structure in Korean industry and the economy at large). Presently, Korea belongs to the top group of R&D spenders in the world economy, but it simultaneously is counted among the highly competitive economies (22nd in the 2012 World Competitiveness Report and the same 22nd in the 2102 World Competitiveness Scoreboard). Korea arrived at the technological frontier and must compete on the basis of its own achievements. Since R&D is regarded as an important contributor to innovation, Korean firms and Korea as a country spend now a lot on R&D (in excess of 3.0% GDP annually).

It is worth stressing, however, that such high spending would not have been possible without corresponding changes on the supply side of the Korean economy. Korean economy, in fact any economy, should—at a certain point of time and GDP per capita level—be able to supply a large majority of the required scientists, engineers, technicians, etc.

It is also approximately at that point that demand begins to be felt more intensively for other sources of intangible capital than R&D. Calculations presented in Table 5.3 point out to the existence of a wide range of intangible capital suppliers. Middle income countries less successful than, say, Korea in overcoming these barriers to continuing economic growth face the prospect of languishing at a given middle income level of prosperity. For the process of economic development is not a deterministic one, suggesting that all countries sooner or later reach the GDP per capita level of the United States. Our experience with industrialization proves that success depends on the quality of institutions and policies pursued within the framework of these institutions. The failure—complete or incomplete—of developmental strategies presented Chapters 1 and 2 in Part I of this study stress the point. Furthermore, there is no reason to expect that the emerging/ongoing experience with the shift to human capital-intensive services would lead to strikingly different conclusions. In the next, and last, section of this chapter the institutional nature of barriers to further economic development facing middle income countries will be considered at some length.

Greater Importance of Institutional Quality in the Second Structural Transformation

In Chapter 4, I stressed the (unpleasant) empirical evidence, referred to by Francis Fukuyama,³¹ that rules of the economic game during the industrialization process need not be good or very good. It is enough, wrote Fukuyama, that they are “good enough.” However, the same cannot be said about the requirements facing middle income countries with respect to the second major phase of structural transformation—the shift from the dominance of manufacturing to that of market services, especially high human capital-intensive services. In this case, the high jump bar is—in my opinion—put much higher.³² And it applies to both economic freedom and civic/political freedom as well.

Before entering into generalizations and comparisons, let me briefly present cases supporting the above statement. These concern research and development as well as higher education. With respect to the former it is worth stressing that Soviet Russia exceeded United States in terms of R&D spending ratio long before the communist collapse—and with no positive effects upon its innova-

³¹ Fukuyama, *The Origins of Political Order*.

³² See Jan Winiecki, “Russia and China Facing the ‘Great Wall’: How To Succeed in Second Structural Transition,” *Post-Communist Economies*, vol. 24 (2011), no. 3, 309–26.

tiveness.³³ For inputs matter less than outputs; quantity in the innovation process means much less than quality. The latter characteristic of innovation depends on institutions. Liberty, not only economic liberty, is of high importance for freedom of research: from choosing the topic to unshackled debate, to publishing the results. None existed at the time in Soviet Russia and there is not much more of it under the present authoritarian regime. The systemic similarity with the Soviet past is too close for comfort.

Let me add, next, some evidence on the quality of higher education from a short, but very informative article in *Wall Street Journal* as well as from my own academic experience. Two authors, A. K. Gupta and H. Wang, wrote (on July 28, 2011) an interesting piece about China as an innovation center, concentrating precisely on the quality issue. Apart from patenting itself, they stressed also a quality problem in university education. They underlined—just as I did above—the politicization of research, something well-known under any despotic regime. Another, but related problem is the low quality of university education, which Das Gupta and Wang ascribe primarily to rote learning. However, the striking deficit in creative problem solving in Chinese education is not only due to rote learning, but—more importantly, I think—to the limitations in academic and other freedoms. The notable passivity of Chinese students stems, in my view, primarily from fear of saying spontaneously something, communist authorities would find offensive or, worse still, subversive.

Therefore students try, wherever they can, to stick to formal models and quantitative analysis. I discerned something similar in the last years of my teaching career in Germany (the years 2000–03). There had been an avalanche of Chinese students in those years, coming for a semester's stay and, since I was lecturing in English, most of them passed through my lectures and seminars.

They were always better at exams, answering formal models-related questions or solving quantitative cases, than answering those questions requiring ability to think creatively about the causal relations between various economic or economic policy-related phenomena. It was even more clearly visible, when they wrote papers for my seminars. Comparisons with the common experience of Soviet times were compelling. Then, too, mathematically gifted students avoided the analysis of “surrealistic reality” of the centrally planned and administered economy and plunged instead into mathematical modeling, thus steering clear of (dangerous) controversies. To repeat, despotic, semi-totalitarian states are not the places where inventions emerge, are nurtured and get frequently transformed into innovations.

The foregoing cases suggest the importance of high degrees of economic freedom, as well as civic, including purely political, freedoms. I tried to explain the importance of the latter freedoms, while differentiating between successful and unsuccessful post-communist transition countries.³⁴

³³ See Winiecki, *The Distorted World*, 188.

³⁴ Winiecki, Benacek, and Laky, *Private Sector after Communism*, Chapter 2.

I stressed repeatedly there that even the best designed and enforced property rights, that is, high quality of economic freedom, may not help much in terms of frequency and volume of business transactions. Such will be the case if economic agents perceive that the safety of their businesses (and of themselves!) is in danger, given the generally low level of law and order due to corrupt bureaucrats, police, and the judicial system. Also, the level of trust in business partners resulting from the successful repeated deals between the parties will not help much if economic actors do not have enough trust in the stability of the existing—at the moment liberty-based—system. That is if they believe that they may wake up one morning to find themselves under the rule of a completely different regime, more hostile not only to private ownership, freedom of market transactions, etc., but also to the wider framework of civic and political liberties needed to further economic growth.

To give an example, they may be accused of crimes, which were under the previous liberty-based regime standard business transactions, with new regime breaking the millennia old principle *lex retro non agit* (the law does not apply retroactively). Or they may be accused of subversion because in some discussions—under the liberty-based past regime—they severely criticized people that came to power or their ideas prevailing in a post-liberty-based despotic regime.

The foregoing considerations apply with even greater strength during the second phase of structural transformation, that is a shift toward the growth engine's role of the service sector. The range of intangible assets required for such economic growth is much greater than during the industrialization phase. Therefore, economic and civic freedoms matter much more in the former shift. Not only scientists working on R&D projects, but a wide range of social scientists and academics working in humanities, scholars and artists licensing their works, architects and designers, advertisers, market researchers—all need a wide range of freedoms in pursuing their activities. And that freedom of necessity must embrace also civic freedoms protecting them from petty vengeance and more serious encroachments of the rulers and their henchmen. It is, then, a *qualitative* change relative to the earlier, industrialization phase. Here, the recent observations of Francis Fukuyama do not apply, as I stressed in my 2012 article.³⁵

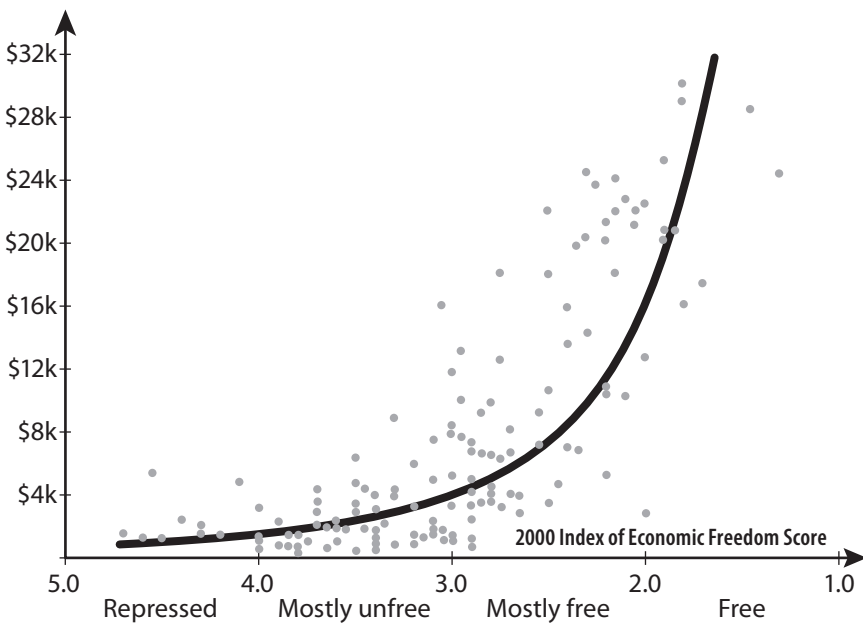
Of course, I have not been the first who stressed the required high quality of institutions—economic, civic, and political—and their relationship with the level of GDP per capita. Antonio Fatás and Ilian Mihov from INSEAD have made similar observations—and supported them empirically—postulating the existence of the strong link between the quality of institutions and economic growth at the middle income level.³⁶ Their set of high quality institutions consisted of both economic freedom and civic freedom variables.

³⁵ See Winiecki, "Russia and China."

³⁶ See Antonio Fatás and Ilian Mihov, "The 4 I's of Economic Growth," 2009; and http://hbr.org/2009/03/another_challenge_to_China's_growth/ar/1.

Their highly important empirical observation was that the strong link between the quality of institutions and GDP per capita appears only after these economies cross the \$10,000–12,000 range. The foregoing observation makes it possible to solve the dilemma that for years existed for those who noted a relatively high correlation between economic freedom and GDP per capita level (see, for example, Figure 5.4) and the increasingly obvious reality of numerous despotic regimes, which grew fast and approached or reached the middle income level, in spite of their institutions being only “good enough,” according to Fukuyama’s formula.

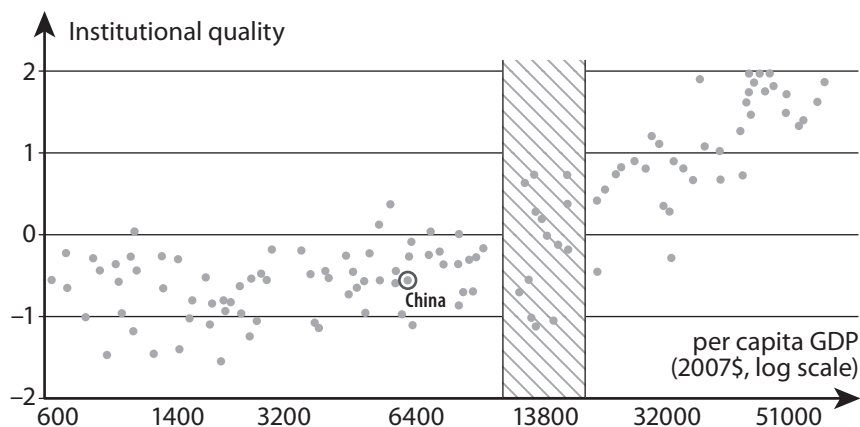
Figure 5.4. Correlation between economic freedom and income (GDP per capita in international dollars of 1997)³⁷



Thus, Fatás, and Mihov proved that a sizable number of countries reached the \$10–12,000 range, which these authors call “The Great Wall,” in obvious reference to the prospective problems of communist China, but did not progress any further (see Figure 5.5). Countries to the left of the Great Wall, that is those with low income levels, display limited correlation with the high quality institutions, while countries to the right of it, that is high income countries, show high correlation between the quality of institutions and the level of GDP per capita.

³⁷ Source: 2001 *Index of Economic Freedom* by The Heritage Foundation and *The Wall Street Journal*.

Figure 5.5. Progressing from middle income to high income depends on institutional quality. Countries have to cross an institutional threshold that Fatás and Mihov call the “Great Wall”³⁸



Fatás and Mihov’s empirical findings complement also those of Eichengreen, Park, and Shin, who noted the slowdown phenomenon, but defined it differently and registered the barrier at somewhat higher level of GDP per capita. Interestingly, Joseph Connors tested my 2012 thesis that the high jump bar is put much higher in the case of the second phase of structural transformation, leading to the dominant role of market services.³⁹ He used both barriers, those of Fatás and Mihov (\$12,000), and those of Eichengreen, Park, and Shin (\$15,000), in his empirical testing and in both cases found supportive evidence for the thesis that not only economic but also civic *cum* political—Connors calls them democracy-related—freedoms are an important requirement.

Considerations presented in this chapter establish certain rudiments of an analytical framework that enables analysts to evaluate the economic growth prospects of countries that approach the important phase of being a middle developed/middle income economy. Looking at their economic institutions, measured in terms of economic freedom, and non-economic institutions, measured in terms of civic/political freedom, as well as evolution of those institutions over time, may help analysts in assessing economic prospects of middle-developed economies of advancing to the level of highly developed economies.

³⁸ Source: Winiecki, *Economic Futures of the West*, 68; and the sources quoted therein.

³⁹ Joseph Connors, “Economic Freedom, Democracy, and Economic Performance,” Duke University, Department of Political Science Working Paper No. 26, November 2012.

Part III

APPLYING THE CONCLUSIONS: BRIC COUNTRIES' DEVELOPMENTAL STRATEGIES

In Part I of this book I analyzed developmental strategies most often applied over the past century (to be more precise, since 1917). Next, in Part II, I presented structural changes associated with the first major phase of such change in the process of economic development, that is, industrialization. Later in Part II, I also tried to draw a rough picture of ongoing changes associated with the second major phase, that is a shift in the growth engine's role from manufacturing to market services, most importantly, to human capital-intensive services.

The first set of conclusions was drawn from the relative performance of economic development strategies, which were to shift growing economies from the category of those driven by agriculture to those driven primarily by manufacturing industry. The aim was to reach a much higher level of aggregate productivity and, accordingly, GDP per capita in order to catch up with the historical leaders in economic development—developed, industrialized countries of the West. The conclusions drawn from the comparative study of the most often tried developmental strategies are very clear. The choice of a strategy based on greater reliance on the capitalist market and on economic openness to the world economy, presented in Part I, Chapter 3, strongly increased the probability of success. The other two strategies failed either completely or largely.

With respect to the second set of conclusions, those concerning the shift in the economic growth engine's role, the shift in question was analyzed in Part II, Chapters 4 and 5. In the former chapter I looked closely at the first major phase of structural transformation, that from agriculture to industry. In the latter I outlined and interpreted the ongoing second major phase of transformation, resulting in the shift from manufacturing to human capital-intensive services. With respect to the latter, I stressed the quantitative similarity in the volume of tangible investment in manufacturing and in services in the developed Western economies.

At the same time, however, I noted—on the basis of a highly innovative empirical literature—the emergence and expansion of *intangible* capital in devel-

oped, high income—generally Western—economies. Its role has been primarily associated with the growth of the market services' sector share in GDP. More importantly for this study of structural change, both the quantity (share in GDP) and diversity of intangible capital are a differentiating factor between middle-developed and developed market economies.

Part II of the study underlined also some differences among determinants of both phases of structural change as well as their enabling factors. The differences concerned primarily the importance of economic and other freedoms as factors of successful second phase of structural transformation. Moderately important with respect to industrialization (note the Fukuyama “good enough” economic institutions in Chapter 4), these freedoms become crucial with respect to the shift from manufacturing to human capital-intensive services. I pointed out, relying on some theoretical and empirical literature, that economic freedoms, even extensive ones, may not be sufficient to complete the second transformation. Civic freedoms in particular, but also political freedom, are very important as well.

Therefore, instead of the—already formulated—conclusions, I decided to complete the considerations presented here with a number of practical applications of what have been stressed in this study. The decision was to consider a number of middle-developed, middle income countries from the vantage point of their economic performance, especially with respect to the first structural transformation and attempted or expected future attempts at the second transformation.

I assume, that although highly developed Western economies face a lot of problems—and mounting problems at that—,¹ their problems are different from those of the success or failure of the second phase of structural transformation. These countries accomplished it in earlier periods.

Thus, I decided to look at the actual economic development path of the countries belonging to the BRIC group. They are countries that for more than a decade have been almost constantly in the news (economic news first of all). They performed quite well, and in the case of China exceedingly well, in terms of economic growth. There were other rapidly growing emerging economies, however. In my opinion the major reason for the former countries' overwhelming presence in the media, as well as in analysts' reports, has also been their *size*: population in the case of India and China, and natural resources in the case of Brazil and Russia. These characteristics, combined with the decade of high economic growth, created incentives for analysts, journalists, and others to pursue various futurological considerations, projecting their dominance in the decades to come.

From the vantage point of this study they are also interesting for yet another reason. None of them historically chose one of the typical industrialization strategies considered in Part I of this book, steadfastly stayed on course, succeeded—and approached the second structural transformation, the “Great Wall”

¹ See, i.a., Winiecki, *Economic Futures of the West*.

in the words of Antonio Fatás and Ilan Mihov (see above, Part II, Chapter 5). Each country went through a number of strategic twists and turns of various proportions. Therefore, BRIC countries are a laboratory of sort for interested analysts, who may look more closely at an intriguing question: which strategic twists and turns, or more broadly, which institutions or policies (taken from which theoretical armory) helped or harmed developmental efforts of a given BRIC country.

It would be tempting to stick to the population/natural resources classification referred to above and consider countries in that order. However, an interfering factor is a common ideological—and to a large extent institutional—history of communist Russia and communist China. Since there has been so much ideological/institutional similarity between these two countries over three decades (1950s–70s) and the impact of that legacy is felt even today, it makes sense to start the analysis with these two countries, and in historical, not alphabetical order. Consequently, Russia and China are considered in Chapter 6, while India and Brazil in Chapter 7.

One general conclusion that comes from an application of the foregoing approach to the four countries in question is that—apart from other characteristics—they also share some pairwise similarities: Russia with China and India with Brazil. The former share consequences of the institutional legacy of communism and central planning of the economy, while the latter share the consequences of democratic political system, with all its short-term disadvantages and long-term stability advantages. Thus, in both pairs, the history of their institutions casts a long shadow.

Yet another, and closing, conclusion is in order. All four BRIC countries face many problems that are going to affect their economic performance in general and ability to cross the Fatás–Mihov “Great Wall” in particular. No country, even that great favorite of punditocracy, that is China, may be facing with any degree of certainty the future of joining the ranks of highly developed, high income economies. It is the democracies considered in Chapter 7 that I see as somewhat better bets in the race to join the ranks of the historical leaders in economic development. For all its faults, liberal democracy is the best (or, in Churchillian terms, least bad) among institutional arrangements. Also with respect to economic development in the long run.

CHAPTER 6

Russia and China: Some Historical as well as Performance Similarities (Up to a Point...)

Russia's Twists, Turns, and Convulsions

Russia, a strong, even if declining, Euro-Asian power at the time, began its industrialization drive in a rather uneventful way in 1880s. A combination of state decisions to assist capitalist industrialization with the resultant inflow of foreign (largely French) capital indeed accelerated the expansion of heavy manufacturing industries. As in the later, Soviet, chapter of Russian history, industrialization was seen primarily as a prop for Russian ability to create a modern technical infrastructure and manufacture the advanced weapons of the era. In other words, it was a reflection of elite imperial ambitions. The aggregate economic effects had been positive, though, increasing the level of wealth, measured in today's terms by the rise in GDP per capita. All this was accomplished under the relatively less intrusive rule (by Russian, not Western standards!).

It is always a precarious venture to consider what might have happened. Here, to Russia's industrial expansion—and economic development in general—without the Bolshevik revolution. However, Stefan Kurowski, in his 1963 comparative study on the historical process of economic growth, formulated a thesis that Russia's development would have reached by late 1950s the same level of industrialization that had been registered at the time by pursuing its pre-Bolshevik revolution economic strategy (see above, Part I, Chapter 1).

The implication of this thesis was that such path would have saved Russia—and more importantly its people—the convulsions during Soviet rule in the twentieth century. This, unfortunately, did not happen. (The only thing that did happen was the dismissal of Prof. Kurowski from his job in the Polish Academy of Science.)

Soviet Russia's industrialization path under the communist rule has been presented in some detail in Chapter 1. The Marxian utopia imposed right after the Bolshevik revolution cost Russians dearly and was called off in 1921. The second collectivist attempt, after the low level equilibrium of a sort had been achieved, was better prepared and lasted over 60 years. It was based on an

invented (“man-made” in Hayek’s terms) centralized economic system of planning and administration and the new “shortcut” industrialization strategy, aimed at the rapid increase in the size of heavy industry (“steep ascent”), under the near exclusive state ownership of productive assets.

Given the system and strategy characteristics, the Soviet-type economy turned out to be an extremely costly venture in terms of resources/outcomes ratios. My own calculations, as well as those of some other Sovietologists and comparative systems analysts, showed that the economy in question usually required 2.0–2.5 times more resources of all types than a capitalist market economy to achieve the same quantity of output (GDP, etc.).

These proportions applied to almost all important indicators. Thus, 1% growth of GDP equivalent required 2% growth of gross fixed capital investment in Soviet Union and other East European communist economies, while it required only 1% growth in capitalist market economies. The use of energy, steel, cement also was 2.0–2.5 times higher per unit of produced GDP than in the West. A similar ratio applied to the inventories/output indicator at the enterprise as well as at the country level.² At the enterprise level employment was also 2.0–2.5 times larger than in comparable Western enterprises for a given quantity of output (leaving aside the abysmal quality of output under communism!).

Thus, summing up the performance of Soviet-type command economy, it accomplished the traditional intermediate developmental aim of all shortcut strategies. It solved the problem of the slow growth of the level of savings by the forced transfer of resources from traditional sectors (agriculture and later also mining). However, the price for the accelerated growth of available resources within the framework of the existing system and strategy was very high. On the one hand, it permanently crippled agriculture, which never recovered till the very end of communism (in fact it did not recover until today). On the other, it created the self-reproducing mechanism of the extreme wastefulness of resources’ use. Over time it became clear that the proclaimed catching up with the developed capitalist market economies could not happen, given the very high—and continuing—level of resource waste.³ And it did not.

I presented in Chapter 1 the relevant statistics for Czechoslovakia, Hungary, and Poland in this respect (see Table 1.4 there), showing a failure even to shorten the distance to the developed West, to say nothing about catching-up. Yegor Gaidar, in turn, wrote that “after pursuing its dramatic path of economic development during the twentieth century, after its experiments with socialism and its collapse, Russia at the threshold of twenty-first century is as far from

² See, i.a., István Dobozi and Jan Winiecki, *Prices of Raw Materials in the Eighties: A Relative Stabilization or a Repetition of the Recent Past?* (Budapest: Institute for World Economy, 1980); Kornai, *The Socialist System*; Winiecki, *The Distorted World*; and *ibid.*, *Economic Prospects*.

³ See Winiecki, *Economic Prospects*, 24–6.

the United States as it was at the beginning of the twentieth century. In 1913 GDP per capita, according to Maddison, was \$1,488 in Russia and \$5,307 in the United States (in comparable prices of 1990), while in 1990 the same indicator amounted respectively to \$6,871 and \$21,866.⁴ In percentage terms, according to Maddison's calculations, the Russia/United States GDP p.c. ratio was 28% in 1913 and 31.4% in 1990, at the close of the communist system there. Relative to other less and middle developed countries Soviet Russia was clearly falling behind.

Russia under the regimes chosen by the victorious Bolsheviks and maintained for the three quarters of a century indeed changed its output and employment structure. Some other indicators changed as well, creating an outward appearance of Soviet Russia as a developed economy. For example, already in late 1970s it spent more on research and development than the United States. However, in reality it was at best a middle-developed, middle income (or less than middle income!) economy. It industrialized, but its production was of very low quality and increasingly obsolescent in technological terms.

The military sector was an exception, but quality and modernity were achieved there at an enormous cost. That specific price, just like the aggregate price for the maintenance of the inefficient system and no less costly strategy, was paid by the disproportionately low living standards of the Russian population. In the case of Soviet Russia there has been a striking discrepancy between the measured GDP per capita and the level of population's well-being. To give just one example, in 1991, the last year of the Soviet Union, private consumption's share amounted to meager 41.4% of GDP, according to official Russian statistics. In the middle-developed, middle income countries of East-Central Europe that joined European Union in 2004 that share was 7 to 15 percentage points higher in the early 1990s—and growing. And, let me remind the readers that these countries suffered for more than four decades from the imposed inefficient communist system and strategy. The difference was that they were on the path of accomplishing a successful transition from communism to democracy and from plan to market.

The other side of the low share of Soviet Russia's private consumption was an oversized share of state expenditures: excessively high gross fixed capital investment, very high military expenditures (partly hidden within the GFCI figures), high R&D expenditures, and also high other traditional public sector expenditures. And, yet, these high expenditures did not contribute to reducing the developmental distance to the West.

In reality, the technological distance (apart from the case of military equipment) has been on the increase at least from mid-1960. The numbers presented in Chapter 1 prove the point with respect to exports. Prices obtained for Soviet machinery and equipment on competitive European Union markets were not only less than half of the average prices obtained by other exporters in 1965, but also the ratio in question had been getting worse all the time, falling in 1985

⁴ Gaidar, *Anomalie wzrostu gospodarczego*, 104.

to less than one quarter of the average prices obtained by others! Research and development spending, higher than in major Western economies—see above—, did not help. Innovation requires economic and other freedoms, as well as a proper structure of incentives—all nonexistent in the Soviet Union.

Next, in spite of accomplishing the (distorted) structural transformation associated with industrialization, as well as becoming a middle developed economy of a sort, Russia failed to reduce the developmental distance. Accordingly, it did not cross the Fatás–Mihov “Great Wall,” dividing the successful and unsuccessful pretenders to the highly developed economy status, due to Soviet Russia’s deficient institutions and policies.

Clearly, the first attempt to join the club of developed market economies was a failure. What about the ongoing, second attempt of the post-Soviet Russia? I use the term “post-Soviet” to signal my doubts about the extent to which a fully-fledged transition to the capitalist market of post-1991 Russia has been accomplished. The first question to be answered is what kind of economy emerged in Russia after the fall of communism?

Thus, for example, László Csaba⁵ classifies the Russian economy as a market economy “in the broadest sense” of the term.⁶ A look at the European Bank of Reconstruction and Development ranking of post-communist transition countries suggests the same, but it shows also that Russia’s rank in various areas of institutional change and in overall assessment puts Russia in the lower middle of post-communist economies. For example, in the *EBRD Transition Report 2001*, Russia, with the overall score 2.3, was far behind not only the early leaders of transition (Hungary, Poland, the Czech Republic), but also behind Estonia (score 3.5), Lithuania, and Latvia (each 2.9). And it is worth keeping in mind that the last three countries underwent not only a change in the political system and were undergoing change in the economic system, but also had to reestablish their own statehood. Their situation was even more difficult than that of post-Soviet Russia.

Why the difference, then? Sovietologist Gur Ofer points to the ambiguity of popular attitudes in Russia toward the West, market capitalism, and change along the lines of Western political and economic ideas. Also, most Russians—who suffered so much from the oppressive communist regime—regretted Soviet Union’s demise, as well the breakup of the empire and the decline in Russia’s status as a superpower. By contrast “the change was embraced by the majority in other transition economies as an act of independence from hated, oppressive colonial power.”⁷

Sentiments and perceptions matter, but in my opinion it is first of all history that casts a long shadow. The eight transition leaders, listed earlier in

⁵ Csaba, *The New Political Economy*.

⁶ *Ibid.*, 275.

⁷ Gur Ofer, “Twenty Years Later and the Socialist Heritage is still Kicking. The Case of Russia,” UNU-WIDER Working Paper No. 2010/59, Helsinki, May 2010, 103.

the study, all belonged to Western civilization, historically associated with the Western Christendom. Russia belonged to the Eastern Christendom, with its own, and different, history. There was no place in that history, e.g., for the competition between temporal and transcendental power; in Tsarist Russia and earlier in Byzantium, the patriarch was only—in communist terminology—a “deputy for ideological affairs” and he would not dare to criticize, let alone challenge the emperor. Also, countries of Eastern Christendom had much less experience with private property and its legal protection. Private property in the West was dated from the time of ancient Greece and Rome. In Russia it was legally introduced only in the second half of the eighteenth century, and even then for the aristocracy, the gentry, and the merchants only. Thus, the institutions attempted in the Russian transition were often seen as foreign to a majority of Russians. And even when introduced, they were resisted in practice.⁸ Thus, common values concerning liberal democracy and market capitalism were clearly missing in Russia’s case.⁹

However, Russian institutions and policies pursued since the fall of communism were even less attractive than the EBRD institutional scoreboard suggested. For there had been (and still is!) a heavy layer of authoritarianism and arbitrariness spread over the whole post-Soviet period of transition. In fact, it has been on the increase of late.

It affected no less Russia’s economic performance. I explained that institutional weakness and inferior performance in Chapter 2 of the 2004 book. An argument concerning property rights is worth quoting here. I stressed that even the best designed laws in this respect will not help much if “economic agents perceive that their businesses—and they themselves—are not protected due to the inefficient and corrupt law and order regime.”¹⁰ The arbitrariness and corruption resulted in what was aptly called “property without rights” regime.¹¹ Adding to the foregoing, the Douglass North *dictum* that the single most important determinant of economic performance is how effectively agreements are enforced helps to explain a feeble, and often pathological, development of entrepreneurship in the Russian market economy.

The market economy we encounter in post-1991 Russia reminds me of less developed Southern economies I described in Part I, Chapter 2. It is an economy run from the center, arbitrarily introducing a variety of inconsistent (and often not observed) regulations and *ad hoc* decisions concerning the emerging private sector. In the Russian economy a large presence of the state in its various manifestations, including the threat of renationalization, is always present. Russia

⁸ See Jan Winiecki, “The Transformation to the Market: At High Cost, Often With a Long Lag, and Not Without Question Marks,” *Journal of Public Policy*, vol. 17 (1997), no. 3, 261–58; and Winiecki, Benacek, and Laky, *Private Sector after Communism*, Chapter 2.

⁹ See also Csaba, *The New Political Economy*, 261.

¹⁰ Winiecki, Benacek, and Laky, *Private Sector after Communism*, 61ff.

¹¹ Stefan Hedlund, “Property without Rights: Dimensions of Russian Privatization,” *Europe-Asia Studies*, vol. 53 (2001), no. 2.

can be defined as a kind of the state that Deepak Lal calls *dirigiste*, while László Csaba a “developmental dictatorship.”

Let us shift attention now from institutions to performance. Russia had been one of those transition economies that were affected by the very large output declines over the 1992–98 period, again in contrast to transition leaders, where the period of decline lasted 2–4 years. Part of that decline was not only inevitable, but also desirable. The first reform government head by Yegor Gaidar decided to reduce both military and investment expenditures, not needed in such volumes in a peaceful country and aspiring market economy.

Sequentially, in a transition economy, other desirable developments should have been those made by state enterprises reducing the new orders for inputs (in order to use the oversized input inventories) and reducing new capital investments—both under the threat of newly introduced “hard” budget constraint, that is, threat of bankruptcy. These, however, happened to a very small extent, given the much stronger support for the state firms from the still important political forces of the old regime. In fact, the long period of output decline was a combined effect of reduced unneeded state expenditures, output declines of unstructured state and privatized enterprises, and the dramatic scarcity of new private firms that should have been starting and expanding their production as transition progressed.

The former decisions were not what some critics of transition called “state desertion.” László Csaba noted that the shrinking share of public expenditures was still substantial by global standards (approx. 35% GDP in the late 1990s). The rapid succession of governments in Russia until the ascendance of Vladimir Putin did not maintain the consistency in economic policies; there was little strategic thinking involved with respect to support for various areas of economic activities sensitive to policy decisions. Moreover, whatever allocational decisions were undertaken, they were usually supportive of the economic patterns of the past. The oligarchs’ driven privatization did the same. Having taken over most industrial, mining, and manufacturing firms, they were naturally concerned with strengthening what they bought (or grabbed as it might have been the case) than in modernizing and shifting to new, more sophisticated activities.

In fact, even the new stability of “illiberal democracy,” in Fareed Zakaria’s term, under the (alternatively) Prime Minister and President Putin did not lead to a more future-oriented economic strategy. In the 1999–2005 period GDP grew by 55% and reached 90% of 1991 level, but the structure of output was still characterized by the industries dominant in the Soviet past, that is heavy industries typical for the middle level of industrialization.

The structure of Russian manufacturing in the post-communist period confirms the conclusion. Apart from the large share of food industry, the largest in both 1995 and 2008, dominant were basic metals and metal products industry (17.6% and 17.8% respectively), machinery, n.e.c., (8.5% and 8.9%), transport equipment (10.2% and 7.0%), and electrical and optical machinery (5.4% and

7.1%), with only the last industry suggesting some structural improvement.¹² No less importantly, Russia's share of manufacturing in GDP was at the low level for a middle developed economy and still shrinking: from 19.6% in 1995 to 16.8% in 2008. Russian industry continued to be uncompetitive even in the domestic market and its relative performance there was largely due to the very deep devaluation of national currency in 1998 (by approximately 75%).

By contrast, Russia continued to register, like many resource-rich less developed economies, an oversized share of mining for its level of development (6.3% in 1995 and 5.0% in 2008).¹³ The dramatic turnaround of Russian output since 1999—by accident also a year when Vladimir Putin became for the first time the Prime Minister of Russia—was largely the result of two factors. The first was the shield over Russian industry created by the sharp devaluation and the second, even more important, was the change in the world price trends with respect to fuels and industrial raw materials. In fact, 1999 was also a year, when oil prices reached its nadir: \$12 per barrel in the first half of that year. By mid-2008 they reached \$138. The outcome of both was that in 2007 the level of GDP from the end of the Soviet period was exceeded, while private consumption achieved the same even earlier: in 2004. Public expenditures, including social expenditures (pensions, etc.) also increased significantly, thanks to the reliance of the budget on much higher oil and gas revenues.

That reliance is now even greater than it was in the post-1970 Soviet era. The share of hydrocarbons amounted to 67% of total exports just before the outbreak of global financial crisis. All commodities reached 85% of aggregate exports. And manufactured exports follow the pattern. Also in 2008, the two largest product groups were capital-intensive ones: coke, refined oil, etc., and basic metals and metal products, which also exceeded 60% of aggregate manufactured exports. One may conclude the following with respect to manufacturing:

1. It remains competitive only at home due to the continuing protection through exchange rate devaluation. Its export performance is very weak; and
2. The few areas of higher competitiveness are typical for a middle developed economy, whose competitive strength shifted from labor-intensive to heavy, capital-intensive industries.

The foregoing suggests that the period of high mineral resources prices, which coincided with the rule of Vladimir Putin, has been wasted from the vantage point of modernizing the Russian economy and increasing its international com-

¹² After Wim Naude, Adam Szirmai, and Alejandro Lavopa, "Industrialization Lessons from the BRICs: A Comparative Analysis," IZA-Forschungsinstitut zur Zukunft der Arbeit DP Nr. 7543, Bonn, August 2013.

¹³ Ibid.

petitiveness, apart from fuels and industrial raw materials. Structural change in the direction of the greater role of science-based (or human capital-intensive) manufacturing was marginal at best. This happened in spite of the potential that existed (still exists?) in the Russian economy, which is associated with the military technology achievements of the Soviet era and Putin's attempt at rebuilding that potential of late. Clearly, the structure of incentives, characteristic of a well-functioning market economy, has not become embedded in the Russian market economy of the post-Soviet era.

There are few empirical studies of the middle-developed economies concerning their investment in the intangible capital and none exists for Russia (see Part II, Chapter 5). However, one may safely assume that the economy, which could not effectively cope with the tangible capital investment in manufacturing and failed to modernize its output structure, is not going to flourish with respect to technologically-intensive industries and especially market services, requiring highly diversified intangible capital. Moreover, such expansion requires more than the basic market structure of incentives. It needs economic, as well as non-economic (civic and political), freedoms, something that in post-Soviet Russia continues to be in a rather short supply.

Thus, the rapid economic growth and rising level of consumption in Russia during the last dozen or more years has been achieved largely due to the combination of factors that owed little to successful transition to the well-functioning capitalist market. People are better off than they were during the Soviet era and there is less political repression. However, an overwhelming part of the modest prosperity achieved during the Vladimir Putin's rule is an outcome of the happy coincidence of that rule with the phase of rising prices of mineral resources in the global economy. Such phases last 8–10 years and in the present cycle that phase was expected to end in the 2013–15 period. And it did. If the past is any guide, it will be followed by a much longer phase of declining and low prices (lasting about 20 years).

Thus, a shift from the middle-developed to the developed economy level (crossing the “Great Wall”)—if it is going to take place at all—will be occurring in the much less propitious international economic environment. And without marked improvements in the quality of Russian economic, and not only economic, institutions it will continue to be an unfulfilled dream also in this century.

China's Convulsions, Failure, Turnaround, and the Glorious Present (But Not Without Question Marks about the Future)

It is difficult to write about the Chinese developmental strategies of the recent past, without invoking the history going much further back than the communist China's Soviet-type strategy (strategies) in the 1949–78 period and the more recent successes of China under the much changed economic strategy and moderately (at best) changed civic and political regime. Nonetheless, given the avail-

able space, references to the earlier periods will be made only if they shed light on failures or successes of the 1949–78 and post-1978 periods.

Thus, the reestablishment of the centralized power of the state under the communist regime after the civil war of the 1940s amounted to the return of the rule by a self-perpetuating elite, exercising supreme authority with no formal checks and balances, typical for the Chinese imperial past.¹⁴

Victorious communists decided to pursue the Soviet-type economic model (centralized planning and administration of the economy) and the same “steep ascent” strategy of the rapid expansion of heavy industry. Financing of the above was to be accomplished also in the Soviet style by squeezing hard the (even more backward) agriculture and transferring the resources to industry and technical infrastructure.

The results were similar to those in Soviet Russia. Just as in the latter country, the mobilization of resources needed to industrialize succeeded. Capital investment reached 30% GDP during the first five-year plan (1953–57). The structural transformation was proceeding apace, that is the share of industry in GDP was increasing fast. By the end of the traditional communist economy period, in 1978, it reached 46.8%, an increase from 12.6% in 1949. Thus, the Chinese economy of the period gave—again, like Soviet Russia—an outward appearance of successful modernization through industrialization.

However, China (like Russia) did not succeed in reaching the really important goal that all less developed economies try to accomplish. Namely, it did not reduce the developmental distance to the developed capitalist market economies. As the United States turned out to be an unattainable target for Soviet Russia, so was nearby Japan for China. As calculated by Yifu Lin, in the 1952–78 period, communist China grew by 2.33% annually, while Japan by 6.69% annually.¹⁵ Worse than that, the Chinese growth rate of the period was lower than that of four little Asian dragons (Hong Kong, Taiwan, South Korea, and Singapore) and even lower than the world economic growth average, which amounted to 2.56% per annum during the period in question.¹⁶

Yet, the quoted author says nothing about the living standards of the population over the period and mentions no convulsions strongly affecting economic performance, including the well-being of the population, while the world renown statistician, the late Angus Maddison, did say, diplomatically, in the same book that “in the Maoist era, its version of communism involved risky experimentation on a grand scale.” The Great Leap Forward and the Cultural Revolution not

¹⁴ Loren Brandt, Debin Ma, and Thomas G. Rawski, “From Divergence to Convergence: Re-evaluating the History behind China’s Economic Boom,” The University of Warwick Working Paper Series No. 117, February 2013, 88.

¹⁵ Angus Maddison, “Six Transformations in China: 960–2030,” in *World Economic Performance: Past, Present and Future*, ed. D. S. Prasada Rao and Bart van Ark (Cheltenham and Northampton, MA: Edward Elgar, 2013), 7–41.

¹⁶ J. Yifu Lin, “The Needham Puzzle, the Weber Question and China’s Miracle,” in *ibid.*, 43.

only resulted in economic collapse (the first) and intellectual/educational retrogression (the second), but also in the population's suffering of major proportions. Accordingly, the failure with respect to the human well-being was much greater than failure of efforts to reduce the developmental distance measured in GDP per capita.

The political change after the death of Mao Zedong and the defeat of the so-called "gang of four" brought to power Deng Xiaoping and his collaborators, who decided to change the economic system in part and economic strategy in full. The results are well-known to everybody. It would be easy to present a range of statistics showing the rapid acceleration of Chinese economic growth, kept very high decade after decade. Or to show the developmental distance being reduced as a result. Or, even more importantly, the shift of a few hundred millions' people from abject poverty to the near-middle class status for the first time in the history of China.

It would be, however, a mere repetition of what has already been done elsewhere. More important from the vantage point of the study of economic development are the questions raised in the oft-quoted Lord Robbins 1966 lectures on the topic, that is why economic development successfully started, what kind of preconditions needed to be fulfilled, and how success was achieved.

To begin with the "why" of economic development, one needs to look for the determination of the leadership to embark on a systemic and strategy change. For it is a factor not often present in history. I think that Deng and his collaborators had by late 1970s been thoroughly convinced about the failure of the developmental path taken by communist China in early 1950s. Everywhere around China were countries within the orbit of Sinic culture which were cases of economic success—either already complete, as in the case of Japan, or in the making, as in the case of four little dragons. The only laggard was communist China itself. Clearly, the situation demanded strategic change—and the direction of change was also clear, looking at the East Asian success stories.

Thus, they were ready to make a strategic shift toward a greater role for markets internally and greater economic openness externally, the strategy presented in Part I, Chapter 3 above. However, internal and external liberalization are not separate successful strategies, as Yifu Lin seems to suggest.¹⁷ A free (or even freer) market in a closed economy is a contradiction in terms; they appear together, with or without a lag. Such was also the story of both Japan and four little dragons. There is no doubt that these countries followed the strategy presented in Part I, Chapter 3.

The post-1978 communist China's strategy belongs—with some departures—to the same family. Economic departures from the developmental pat-

¹⁷ Ibid., 60ff; and more extensively in J. Yifu Lin, F. Cai, and Z. Li, *The China Miracle: Development Strategy and Economic Reform*, revised ed. (Hong Kong: The Chinese University Press, 2003).

tern were leaning in the direction of historical Western developments. Political departures were, however, more in the nature of some despotic regimes, which shifted from the *development economics*-based strategy to some combination of more markets and greater openness, but in the political realm maintained their despotic rule.

At that—low—economic development level, economic departures mattered more and contributed to economic success. Thus, the Deng-led Chinese leadership started with a major institutional change in agriculture. One of the preconditions of successful industrialization has been a sustained increase in agricultural productivity. This is exactly what happened over a number of centuries preceding the industrial revolution in Britain. Agriculture's de-collectivization at the start of Chinese reforms gave a strong boost to agricultural output, which increased by 7–8% annually over a number of years. Further institutional change in agriculture was slow in coming, but the return to family farming (even without fully-fledged private property rights) was a sufficient incentive for many years to come.

Another surrogate for the evolutionary development of the West has been the tendency of the Deng-led leadership to experiment first, before embarking upon a countrywide reform in a given area. This was a surrogate for the historical trial-and-error economic development in Western Europe. Not a perfect substitute, of course, but again a surrogate errors' elimination or, at least, errors' cost reduction tactics. Accordingly, certain preconditions of success were created and pursued more or less consistently over the following decades of high economic growth, when reforms moved from agriculture to industry.

Next, an important feature of Chinese development in the post-1978 period has been its uninterrupted high GDP growth rate. This is in stark contrast with post-communist countries undergoing the transition to the capitalist market, where output declines were deep everywhere at the start and long-lasting in less successful transition countries (see post-Soviet Russia above). Such a feature has been widely interpreted as a mark of success of Chinese reforms and of failure of European transition from communism to the market.

However popular, the interpretation is wrong on two, related counts. First, it does not take into account the level of economic development. Here, a Russian economist (and for a short time also a policy maker) Yegor Gaidar points to the major difference in terms of consequences of different levels of economic development between communist China on the one hand and communist Russia and other East-Central European countries on the other. He stresses that the "departure from socialism," as he calls it, while maintaining positive economic growth, is possible only at an early, low level of economic development. At that level it is still possible to continue with the shifting of labor from low productivity agriculture to newly expanding, efficient, and profitable manufacturing industries, operating in accordance with the capitalist market rules of the game. The foregoing, plus—let me add—effects of positive change in agriculture, underpins uninterrupted economic growth.

At a higher level of economic development, when such simple contributions to economic growth have been all but exhausted, extensive structural adjustments in the industrial sector have to be made, accompanied by the decline in output unneeded under the market regime.¹⁸

As far as output unneeded under the competitive market system is concerned, many state-owned enterprises (SOEs), unviable from the start, cannot be reconstructed and have to be closed. The more sophisticated the industry, the greater the impact of such a legacy of the command economy. And if the Chinese authorities decided not to tackle the problem in the early reform period, the problem will keep returning with every weakening of the economy, when subsidization of these zombie-firms will be weighing more heavily than in good times. Over the past three decades such moments were few and far between, but the Chinese economy not only grows, but changes its structure in the process. Under such circumstances problems may recur more often in the future.

It has been clear that the limited (albeit growing) extent of economic freedom, as well as very limited civic and political freedoms, did little damage to performance of the Chinese economy. Its growth performance has been extremely good. This is in accord with the thesis of Francis Fukuyama, presented in Part II, Chapter 4, above. Prof. Fukuyama stressed that the quality of economic institutions need not be excellent; they may succeed even when quality is “good enough.”¹⁹ I suggested in Chapter 4 a limitation of the Fukuyama thesis. Namely, that it applies only at a relatively low-to-middle level of economic development. It is possible to succeed with “good enough” institutions in the process of industrialization, but not at the level of mature industrial economy and the shift from the dominant role of industry to that of human capital-intensive services. Moreover, the quality of institutions’ requirement applies to economic, civic, and even political institutions. The foregoing is supported by the empirical research referred in Part II, Chapter 5.

Uninterrupted, high economic growth puts China within reach of the middle-developed, middle-income economy level. Many economic projections made throughout the world predict China is going to reach the status of a developed market economy at a particular year in the future. They do so, however, without taking into account the quality of institutions or at best assuming that a change from “good enough” to excellent or at least good institutions will (automatically? miraculously?) happen at some point in the future. But nothing is automatic in economic or any other kind of reforms. The “anointed” successor to supersede the United States in the role of the most important world economy, like any other middle developed economy, needs to cross the barrier separating the middle-developed from developed market economies (the Fatás’ and Mihov’s “Great Wall”) if it wants to transform itself into a latter type economy.

¹⁸ See Gaidar, *Anomalie wzrostu gospodarczego*, Chapter 4 and conclusions on 104.

¹⁹ Fukuyama, *The Origins of Political Order*.

Besides, there are not only positive growth effects accumulating over time, but also distortions, again accumulating over time, which need to be addressed at some point if such a transformation is to be accomplished. I already mentioned the SOEs' role in Chinese economy, which became more important (given their political clout) in the more recent part of the post-1978 period.

An even more serious problem concerns accumulating structural distortions. The rapid growth of the Chinese economy rested on two pillars: on the rapid increase in gross fixed capital investment (GFCI) and on a no less rapid increase in exports. The numerical results in terms of the growth of both indicators were very impressive. However, both are under pressure, which is reducing their prospective impact on economic growth in the future.

Foreign trade is a simpler case. First and foremost, communist China, like Japan and the four little dragons before it, benefited from the steady and growing demand of the developed West. However, Western economies have been registering a continuous decline in economic growth rates over a number of decades, now growing at the range of 1–2% annually (with the prospects of further declines in the future). With slower growth, Western imports will be slowing as well and China and other exporters, both of commodities and manufactures, are going to be adversely affected. In fact they are already being affected: China registered a steep decline in the share of exports in GDP from 38% in 2007 to 26% in 2012. The Great Financial Crisis in the West might have probably contributed to the steepness of decline, but not to the emerging trend.

The reliance on foreign trade as a growth factor has been excessive for the size of the Chinese economy in any case. The smaller the country's economy, the larger usually is its reliance on exports. China, with its very large population and large aggregate GDP, was far above the trend line in this respect.

The story of investment is more complex and requires some historical references. Typically, a less developed economy (LDC) makes an effort during early industrialization to increase the share of savings and investment in GDP. Communist China, in spite of its Soviet-style overgrown heavy industry and large military complex, was still a less developed economy in terms of its GDP per capita in 1978, at the moment of the strategy change. Generally, a shift from, say, 10% share in GDP to 20% or more should be expected in a typical LDC. China, however, was not a typical LDC, but a strategy changing communist centrally planned and administered economy, with its typical excessive share of investment in GDP and excessive average investment growth rate/GDP growth rate ratio. Already at the start of its 1978 transition to the market, China's GFCI share in GDP was exceeding 30%.

Thus, any increase in investment ratio was from that very high level. During the post-1978 era Chinese achieved a lot. They built the technical infrastructure needed for an industrializing economy. They completed the middle phase of industrialization understood as a shift from the dominant labor-intensive to dominant capital-intensive branches of manufacturing. Now, they are

looking ahead to reaching the pinnacle of industrialization in our times, that is, to yet another shift to the human capital-intensive branches of manufacturing and to a shift to the dominant role of human capital-intensive services. In other words they are looking ahead to crossing the Fatás–Mihov “Great Wall,” dividing the middle developed, middle income from developed, high income economies.

However, to accomplish the next structural change they need to change a lot, both in terms of economic structure and in terms of institutions underpinning such a structural transformation. One change, enforced by external circumstances, is underway, that is the shrinking contribution of exports to economic growth.

Another will be more difficult. In its quest for economic growth and, additionally, in its (rather reckless) response to economic slowdown caused at the nadir of Western financial crisis, Chinese authorities relied mostly on public sector infrastructural investment and on state-led SOE investments. In consequence, the share of investment in GDP increased from the already extremely high 43% in 2003 to an aberrant 49% in 2011. The latter share is unsustainable in the longer run. Clearly, the efficiency—and at times even the usefulness—of investment must have suffered under the circumstances.

Incremental capital output ratio in Chinese economy increased to the old pre-1978 levels (4.6:1 in 2011). Moreover, the level of financing of the economy has increased sharply: \$1 of new credits generated in 2012 only \$0.17 GDP, while in 2007 it was \$0.83.²⁰ Some analysts, looking at the foregoing numbers, predict an economic collapse.

However, they do not take into account the fact that communist China is a financially repressed economy, where the government sets an interest rate ceiling on deposits and well instructed state-owned banks undercharge SOEs in their lending policies. According to some estimates, the transfer from households to big borrowers amounts to about 4% GDP annually in the twenty-first century.

The Chinese investment strategy is unsustainable due to its growing inefficiency and unused (unusable?) excess capacity. The political authorities seem to understand the issue and governmental Development Research Center envisages the decline by 2022 of the share of investment in GDP to 42%.²¹ The economy is inevitably going to slow down as a result of this and other changes on the way from investment-led and export-led economy to a consumption-led economy. Among these other changes is an expected change in the structure of produced GDP, with industry’s share declining from 45% to 40% and that of services increasing from 45% to 55% in 2012.²² Furthermore, projected changes appear to be in the right direction in terms of the required second transformation, that is, shifting the engine’s role in economic growth from industry to market services.

²⁰ “China’s Reform Movement,” *The Wall Street Journal*, June 27, 2013.

²¹ Martin Wolf, “Why China’s Economy Might Topple,” *Financial Times*, April 3, 2013.

²² Ibid.

Typically, Keynesian Cassandras see the threat of economic collapse in the decline in investment. *FT* deputy editor Martin Wolf is of that opinion (see above), as well as the Nobel Prize winner Paul Krugman. This is, however, more an echo of old worries of “development economists,” seeing in investment-based Harrod–Domar-type models “the one and only” path to economic development, than a real threat under a cautious macroeconomic policy coupled with both tighter regime for state-owned enterprises and liberalization of financial markets. In reality, structural change in terms of the shrinking share of investment in GDP will have to go much further than 42% expected by analysts from Development Research Center. In the history of economic development a share of investment exceeding 40% GDP over a longer period happened in rare cases— and was on its own a cause of usually sharp economic decline.

I see, however, more probability of slow growth in the future for other reasons than the much needed large cuts in fixed, tangible investment. A shift from middle-developed, middle income economy to a developed, high income economy is associated with the increased role and diversity of what has been called recently *intangible investment*. This, in turn, requires much more economic freedom than is offered at present in communist China, as well as civic and political freedoms that are very scarce commodities in that country.

Chinese leadership seems intent to pursue the historical path of the economic expansion of the West in second millennium, n.e., that was driven by increasing economic freedoms, as a foundation of wider systemic change. However, they tend to postpone the much needed extension of civic freedoms and leaving for some very distant future political freedom. There seems to be some understanding that changes in both—civic and political—areas are necessary if China is to become a developed, high income economy. For example, the program of new leaders in charge envisages the reform of the judiciary in the direction of judicial independence. If indeed introduced, it would be a real change. The judicial role of political leadership has been a foundation of power throughout despotic periods of Chinese history, whether imperial or communist.

The procrastination on this and other aspects of civic freedoms (let alone political) is highly probable, given the allergic reactions of the ruling elite to even modest manifestations of free debate. An example of firing a professor who held seminars on Western thinkers such as, John Stuart Mill²³ tells a lot about the mentality prevailing within the ruling stratum.

However, without the comforts of these freedoms, the new ideas and their applications may be few and far between. Pundits note, for example, that China has been increasing its level of R&D expenditures, which is exceeding now 1.5% GDP. Yet it is worth remembering that Soviet Russia surpassed the United States in terms of the R&D/GDP ratio already in 1970s without any benefits in terms of

²³ On this, see: “Academic Freedom: Don’t Think, Just Teach,” *The Economist*, February 15, 2014.

inventions and innovations, and the reduction of technological distance to the United States generally.

A highly instructive piece of evidence with respect to the value of some technological statistics concerning China has been offered by A. K. Gupta and H. Wang in their article in the *Wall Street Journal*.²⁴ They inquired into the quality of Chinese invention statistics, looking at the issue from the angle of the number of patents. However, as they pursued a quality issue, they decided to create a category of inventions important enough to be registered not only domestically, but in the three major innovation centers, that is the United States, European Union, and Japan. Then, they selected American, European, and Japanese inventions also registered there and compared the numbers.

The picture they obtained was sharply different from the standard one. When all patents were compared, the number of patents registered in China amounted to about half of those registered in the United States (approx. 200,000). However, when only important patents were taken into account, it turned out that in 2008 Chinese registered only 473 such triple patents, while Americans, Europeans, and Japanese filed approximately 14,000 such triple patents. Thus, the ratio between China and the technological leaders changed from 1:2 to 1:30. Clearly, most of the patents in China are minor improvements to major innovations (and a majority of these patents are registered by Western firms or joint-ventures with Western firms).

Patents are, of course, only one area of intangible assets. But freedoms, not only economic freedoms, are a necessary ingredient in the spontaneous development of all kinds of intangible assets. And investment in such—extremely varied—assets is a hallmark of becoming a developed, high income economy, where intangible investment increases rapidly and reaches the size of tangible ones in terms of share in GDP at some point in the future. With the prevailing thinking and reactions of the ruling stratum to greater freedoms, there is a threat of China languishing, like Russia, before the “Great Wall.” And, characteristically, for similar reasons.

²⁴ July 28, 2011.

India and Brazil: Two Perennial “Great Potentials”

India, Its Strategies, Half Turns, and (Indeed) Great Potential

India and Brazil, apart from being the other half of the BRIC, whose developmental strategies are considered in this part of the book, share also another distinction. They have been for quite some time perceived as countries with great economic potential. In fact, their potential role has been stressed also beyond the realm of economic affairs. However, as it often happens with “great potentials,” they often disappointed believers.

The foregoing has applied for a longer period to Brazil than to India, mostly for two reasons. Firstly, Brazil has been independent in modern history for much longer. And, secondly, its riches in terms of natural resources were already noted in the nineteenth century. And it is worth remembering that the pattern of world trade in that century was dominated by commodities, not by manufactures as in the twentieth century, especially since World War II.

India, a younger modern country, but a very much older civilization, had to wait until its independence in 1947 to begin to be perceived as a country of great potential. The discovery was associated with the assumed role of India as a poster boy of the new “progressive” economic strategy based on the set of ideas called *development economics*. The strategy assumed, as it was stressed in Part I, Chapter 2, that to initiate or accelerate economic development a poor, less developed country needed to manage the economy from the center, pursue forced industrialization and (inevitably) forced savings, as well as to strictly control economic relations with the outside world.

Since this was very much in line with the thinking of the dominant Congress party and its top leader and ideologist, Jawaharlal Nehru, India embraced the progressive, democratic socialism-imbued thinking on economic, social, and other issues. Nehru added here another feature, an extensive economic planning. Some concessions were made to the Gandhi-type traditionalists who extolled the subsistence-oriented craftsmanship and agricultural smallholdings-based economy, but such ventures added only complications, without much

affecting the developmental strategy. This was based on the dominant role of the state in investment, establishment of the state-owned heavy industry, build-up of the physical infrastructure, as well as detailed and increasingly bothersome (“Kafkaesque” to remind the apt term used by Jagdish Bhagvati) controls over the private sector.

On top of the adopting the panoply of the then fashionable, progressive measures, India—given its size and the personality of its leading politician—was seen at the time as an informal leader of the poor, unaligned countries, a “Third World,” trying to stay away from the cold war shaping up between East and West. Processions of interventionist economists travelled to India in the 1950s to see the shape of things to come and hoping to be able repeat the optimistic statement of Sidney and Beatrice Webb who, after a visit to the Soviet Union in 1930s, wrote the famous conclusion: “We have seen the future and it works.” We now know it did not work, but that was not the perception of the era.

So, India was then *en vogue* and any economist who dared to suggest in 1950s and 1960s that, for example, countries such as Taiwan or South Korea, both equally poor during the 1950s, and, moreover, recovering from wars, could do economically better than India would be laughed at. South Korea? In fact, at that time it was communist North Korea that was seen as an economy with greater potential of the two, given its industry, built during the Japanese occupation, and its mineral riches.

The Indian elite was largely Brahmin in its caste origin and it took to managing of the economy from the center and to detailed planning like duck to water. After all, they were coming in a large majority from the highest, that is, from priestly Brahmin caste. They were the ones who, according to Hindu sacred ancient texts, possessed the power of the word, meaning they were the only caste permitted to read and write. Millennia later, in the different socio-political and ideological environment, they spotted in the chosen developmental strategy an opportunity to continue their rule on the basis of temporal, not only transcendental rationale. They now had the power of the word on economic issues.

The performance of the Indian economy under the new, *dirigiste*, regime and its bureaucratic planning framework was uninspiring from the start. Economic growth was on average lower than in many other less developed (Third World, now Southern) economies, pursuing the similarly inspired developmental strategies. Over time, again as elsewhere, the slowdown became increasingly noticeable. Problems of economic growth were superseded by growth of economic problems, to use the saying popular among economists of the era.

The reasons were the same everywhere, as described in Part I, Chapter 2. Namely, as the economy shifted on its development path from an easy to a more difficult phase of import substitution, that is, policy makers and planners forced an expansion of manufacturing industries for which a given country did not possess economic competence, output growth slowed, while input costs skyrocketed. In India incremental capital/output ratio (ICOR) went up from relatively high

4.0–4.5:1 in the mid-1960s to a very high 10.5:1 in the mid-1970s. The concentration on heavy industry resulted in declining efficiency: state enterprises received approximately 70% of investment, but produced only 30% or less of industrial output in return. It is worth noting that total factor productivity of the India's economy was negative for most of the 1947–90 period!

Mounting economic problems began to be accompanied in India at a certain point by a marked tilt toward idiosyncratic socialist-style autocracy under the prime ministership of Nehru's daughter, Indira Gandhi. She saw the recipe for reaccelerating economic growth in tighter control over not only the economy, but also over society. Fortunately, she failed. The unimpressive economic growth rate of the first three five-year plans (1950 to 1965) slowed down in the next 15 years under the ever more slowly operating (and more erratic) administration and planning. Measured by GDP per capita, growth declined from 1.9% to 1.3% per annum.

Of course, India, as all countries pursuing one or another "shortcut" strategy, succeeded in increasing the savings rate, doubling it over the 30 years period between 1950 and 1980. And the rate increased somewhat higher to 20%-plus in the 1980s. But the efficiency of their use under the adopted developmental strategy was very low.

Besides, the heavy industry-oriented strategy deprived India of two potentially important—and intertwined—developmental achievements. First, the strategy created almost insurmountable obstacles to the expansion of manufacturing industries, in which India indeed had comparative advantages, namely light industries based upon the intensive use of the most plentiful production factor available in India, that is, unskilled labor. Although light industries required little capital relative to labor in comparison with government-favored heavy industries, even that little was very difficult to obtain—or not available at all. An important companion of the underdeveloped light manufacturing, were underdeveloped exports of light consumer goods. Over time, then, India fell further and further behind other countries that were rapidly increasing their manufactured exports. The traditional industrialization pattern that attracted rural labor to manufacturing industries requiring little skills was stalled as a result. The manufacturing sector's share in GDP and even more in employment increased at a snail's pace (favored heavy industry did not require much unskilled labor!). This distortion continues, unfortunately, until this day, but more will be said about it later.

Thus, as I wrote elsewhere about that period of Indian economic history,¹ the country got less economic efficiency, less employment than would emerge under the spontaneously developing economy, and less ability to compete internationally in light industries' products. In return, India got heavy industry that was unable to compete even in the domestic market, and which, therefore,

¹ See Jan Winiecki, "The BRIC Group—How Strong a Challenge to the West," *World Economics Quarterly*, vol. 13 (2012), no. 2, 1–44.

required a high level of protection. Import demands, not compensated by export increases, resulted in repeated current account crises.

On the plus side it is worth stressing the benefits of establishing and maintaining the democratic system (in spite of temptations, see the Indira Gandhi's rule!). As Fareed Zakaria put it, diplomatically, "men like Jawaharlal Nehru may not have gotten their economics right, but they understood political freedom and how to secure it."² Democracy helped, without doubt. India was saved the horrors of Soviet/Chinese-style experiments and—in consequence—human disasters.

One of the acute current account crises was turned from threat into opportunity. The then Finance Minister and later Prime Minister, Manmohan Singh, got a (reluctant) acceptance from the leader of Congress party, Sonia Gandhi (widow of an earlier leader, Rajiv Gandhi, murdered by a fanatic) for liberalization of the economy as a way to deal with repeated crises, and more generally with the problems bedeviling the Indian bureaucratically planned economy for decades. What Manmohan Singh did was to do away with the most costly and intrusive regulations of the product markets. He scrapped the two types of most intrusive constraints:

- The rules that all new establishments, new investments in old establishments, changes in output levels of actually produced goods, as well as introduction of new goods had to obtain an approval from the planning bureaucracy; and
- The rules that all imported investment goods and all imported production inputs also required an approval of the respective bureaucracy.

The foregoing liberalization, however limited, was enough for the long suffering Indian entrepreneurs to behave in accordance with the economic principles going back to Adam Smith. Once they saw the economic opportunity, they seized it—and many succeeded in this endeavor.

In spite of the sharp criticism from unrepentant believers in socialism (that was in retreat or crumbling everywhere in early 1990s), as well dire predictions that the economy was going to stagnate under the impact of chaos of an unplanned development and less controlled imports, the economy thrived. Freed from both the time-consuming and often also bribe-consuming activities of the "Permit Raj" (as an archetypal Indian bureaucrat used to be called), producers responded positively to the new freedoms. The current account crisis was alleviated in the next few years and in the 1994–97 period Indian economic growth accelerated to a 7.5% annual rate, a historical record at the time. Later, in the 2003–10 period, that growth rate was even higher: 8.5%. Even a slowdown in the recent years was still markedly above the average pre-1991 growth rate.

² Fareed Zakaria, *The Post-American World: Release 2.0* (New York: Norton, 2011), 156.

The social effects were also strongly positive. The share of the poorest population, according to the official poverty line declined from over 40% in the pre-1991 period to 26%. And according to the more demanding criteria that indicator improved from 45% at the beginning of the reform period, in 1993, to 32% in 2010. Significantly, a relatively large middle class, about three hundred million strong, emerged in the post-1991 period. And, since the middle class has been everywhere the strongest supporter of freedom-enhancing reforms, their successes created a (growing) constituency for future positive changes in this respect.

The new, large, and growing middle class is a middle class of entrepreneurs and professionals, not the middle class of well-paid bureaucrats (of largely Brahmin origin), concerned primarily with their status, as well as opportunities for patronage and corruption. For the time being the latter, present in both major parties and in the constitutionally irremovable bureaucracy, as well as intellectuals imbued with the 1960s style socialist ideas, succeeded in grinding reforms nearly to a halt. Hopefully, the new—and growing—middle class is becoming stronger and more vocal. In its aims it is supported by economic superstars, self-made billionaires of the Indian business. It is of these people that Manmohan Singh said: "These are not the children of the wealthy. They are the children of liberalization."³ Finally, Indians could succeed in India; outside India they succeeded much earlier. For it was not without reason that an Indian parliamentarian asked pointedly an authoritarian PM Indira Gandhi the famous question: "What is it that Indians seem to succeed everywhere except in their own country?"

The removal of the most bothersome, Kafkaesque barriers to initiative, entrepreneurship, and innovation changed a lot, even if a lot more—in terms of institutional change and good policies—is required if India is to become a thriving middle-developed, middle income economy and then move forward to cross the "Great Wall," dividing the middle-developed from highly developed, high income economies (see Part II, Chapter 5 above). In spite of all the gloom of those inside and outside India about the present slowdown of the Indian economy and unclear reform prospects, India is (surprisingly) well positioned to meet the challenge of shifting to the human capital-intensive, highly developed high income economy at some point in the future.

Let us look, then, at certain atypical characteristics of the Indian economy. The traditional pattern of economic development entails two major structural shifts. The first is the transformation from agriculture-driven to manufacturing industry-driven economy. And within manufacturing the change takes place from unskilled and semi-skilled labor-intensive industries to capital intensive industries. Much later in the phase, when manufacturing begins to decrease as a share of GDP, the growth engine role is taken by modern, technology-, or human

³ Swaminathan S. A. Ayar, *Escape from the Benevolent Zookeeper* (New Delhi: Times Group Books, 2009); quoted after his CATO Institute, Development Policy Analysis Paper No. 13, July 20, 2011, 7.

capital-intensive industries. In the second major transformation (see Chapter 5 above) the growth engine's role is taken over by human capital-intensive market services in interaction with the (small) number of the foregoing innovative, technology-intensive industries. That pattern has been followed by the leaders in economic development, that is, in the West, and it has been taking place in some countries of the South.

India has differed in important respects from that pattern, both in its successes and in failures. The contrast between both has probably been best expressed in Fareed Zakaria's remark: "The country might have several Silicon Valleys, but it also has three Nigerias in it—that is more than three hundred million people living at less than a dollar a day."⁴

Undoubtedly, the unusual pattern of economic development is strongly evidenced by the thriving information technology and biotechnology industries, the industries of the last stage of intra-manufacturing structural change, typical for countries at a much higher level of economic development, as conventionally measured by GDP per capita. Exactly the same may be said about the vast expansion of human capital-intensive services, often interlinked with the foregoing industries. These services are not only expanding domestically, but are also competitive internationally. The share of services in aggregate exports of India is on the level of the average share for the European Union countries (roughly 25%).

Whence came the success? To begin with, it is worth first discarding a type of explanations that cannot survive even a momentary scrutiny. Thus, Robin Douhan and Anders Norberg accuse the reformist government of Manmohan Singh that it "has favored the growth of high-tech service sector."⁵ Rashmi Banga takes a superficially opposite view in his paper, wherein the author, while trying to explain an uneven pattern of growth within the service sector regrets that in contrast to agricultural and industrial policies, there is no integrated governmental policy with respect to services.⁶

Although differing in their conclusions, authors of both papers display the same type of tinkerer's attitude. They all see the government as the main—if not the only—driver of economic change. No change is going to happen without governmental intervention, strategic or other! This is simply untrue in historical terms, as spontaneous economic development has been the main driver of change in the West for centuries, and it is even further from reality with respect to India.

India indeed had, very detailed, agricultural and industrial strategies with limited successes with respect to the former (assisted also by the technological green revolution coming from outside) and none with respect to the latter in the

⁴ Zakaria, *The Post-American World*, 133.

⁵ R. Douhan and A. Norberg, "Is the Elephant Stepping on its Trunk? The Problem of India's Unbalanced Growth," Stockholm, Research Institute of Industrial Economics Working Paper No. 788, 2008, 5.

⁶ Rashmi Banga, "Critical Issues in India's Service-led Growth," New Delhi: Indian Council for Research on International Economic Relations, October 2005.

1947–90 period. If anything, the industrial strategy turned out to be a blind alley from which the reformers in the post-1991 period has been slowly (too slowly!) trying to redirect the industrial sector. Too slowly, because the traditional manufacturing sector, that is light, labor-intensive, and heavy, capital intensive industries did not expand and restructure fast enough to increase their share in output and employment. Manufacturing's share in GDP increased barely by 1.5 percentage point between 1980 and 2008: from 14.9% to 16.4%. The change in aggregate employment's share was not much better.

The striking difference in the performance between the high-tech human capital-intensive manufacturing and the same type of services as opposed to traditional, early and middle phase light and heavy manufacturing industries stems from completely different, in fact opposite, reasons than those stressed by Douhan and Norberg. The impressive expansion of the former comes primarily from the fact that they were new and began their rapid expansion mostly after the 1991 liberalization shift. Thus they were not subjected to the numbing flow of regulations, discretionary decisions, and associated corruption, characteristic of the Permit Raj regime. In simple terms, the Permit Raj did not have enough time to regulate, plan, interfere, accept or reject—to create the maze of Kafkaesque intrusions into business activities in these new sectors.⁷

Summing up, the successful firms in manufacturing and market services had *the advantage of not having been covered by governmental strategies, plans, ad hoc interventions, and associated corruption*. In the foregoing approach I am not a lone voice. A former chief executive and now consultant and commentator, Gurcharan Das suggests, tongue-in-cheek that "the government sleeps at night and the economy grows" (roughly a title of his recent book).

Traditional manufacturing, construction, and even more the private and municipal services were there from the start of Nehruvian "democratically-planned collectivism" subjected to the rule of Brahmin/socialist bureaucracy and its attendant corruption. So, in contrast with modern, late stage industries and services they could not avoid the time-consuming and bribe-consuming intrusions. Although the most onerous characteristics of the Permit Raj have been abolished, the bureaucracy with its regulations and *ad hoc* intrusions is still present almost everywhere. And it is reinforced by the "progressive" labor laws that started under the British rule and were not only continued but expanded over the first decades of independent India. No less than 51 central government and 170 state government regulations makes it next to impossible to dismiss employees (and in the case of bureaucrats, teachers, and many others in the public sector it is legally impossible).

Thus, apart from the maze of rules throttling the initiative of entrepreneurs in the private sector, there is an extra barrier strongly discouraging the growth of successful firms. It is—like, for example, in Italy—the threat of being

⁷ See Winiecki, "The BRIC Group."

subject to the labor laws that can cripple their performance. So, there is in India a “missing middle” phenomenon, known from other countries with heavily over-regulated labor markets and too strong labor unions. That is, there are very many small private firms (relying in a large part on informal employment) and some very large private firms, but the share of middle-sized firms—the backbone for example of the German economy—is much too small.

Clearly, manufacturing, construction, and traditional private services are even more eagerly awaiting the “second generation of reforms” suggested by Mohammed el-Erian and Michael Spence⁸ than the rest of the economy. Without such reforms the delivery of low to middle skill-based jobs for those who will never make it in the high-tech, human capital-intensive industries and services, will keep three hundred to three hundred and fifty million poor peasants and town dwellers in the state of heart-rending poverty. But the road to success should not be based on the much-loved detailed governmental strategies and plans, but on the far reaching loosening of the still existing regulatory barriers, the reduced role of bureaucracy, and the reduced corruption. All three aims of such withdrawal strategy are interrelated and cannot possibly be achieved in isolation. Moreover, as stressed, i.e., by Jacob Kirkgaard, India faces a double educational challenge of not only expanding higher education, but also improving primary and vocational education.⁹

Let us list the areas most urgently requiring such second generation reforms. A perceptive article, “The Half-finished Revolution” in *The Economist*¹⁰ distilled the range of recommendations and summed them up in the following statement. The 1991 reforms freed—with all the reservations made above—the products and services markets. Now it is the time to free the factor markets. And indeed the overregulation, bureaucratic procrastination, and corruption affect most strongly these markets:

- The most notorious labor market has already been mentioned more than once. It is obvious that if firms cannot dismiss workers, they will not hire workers in the manner beneficial to both employers and employees. If you cannot fire bureaucrats or teachers, they will neglect their duties with impunity. The net result is the existence of two classes of workers: those with much higher job security and wages and those on renewable contracts with wages up to four times lower. Privileges of some are a burden for the majority of others. According to some estimates, up to 85% of workers in the Indian economy belong to the latter category. The much

⁸ “Why the West Should Pay Attention to India’s Woes,” *Financial Times*, October 26, 2011.

⁹ See J. F. Kirkgaard, “Offshoring, Outsourcing, and Production Relocation Labor Market Effects in the OECD Countries and Developing Asia,” Peterson Institute for International Economics Working Paper No. 07-2, Washington, DC, April 2007.

¹⁰ July 23, 2011, 52–3.

needed jobs in traditional light manufacturing industries are not going to materialize without the changes in the labor laws.

What is needed to open up the employment in the public sector is the abolition of constitutional guarantees of job protection in the public administration. If a bureaucrat cannot be removed even in cases of proved corruption, such impunity only entrenches corruption in the system. The brazen neglect by many teachers of their duties also remains unpunished under the present regulations.

- Regulations of the financial sector and its ownership structure are both an obstacle to the efficient allocation of capital. Most banks and general insurance companies were nationalized during the Indira Gandhi autocratic rule and remained so. Even now, with the expansion of new private banks, about 70% of all assets are still created by the state banks (even if many assets are of dubious quality).

The bureaucracy and corruption makes these banks a difficult partner for both medium-sized and small firms, as well as for farmers. Edward Luce, a British journalist living in India, notes, i.e., in his perceptive book that in a survey of 2002 a majority of interviewed farmers said they trusted local money-lenders more than public bodies, delivering various services¹¹ and added that they could just as well have said the same about public sector banks.

- One of the continuing major problems of India's economy is the antiquated technical infrastructure perennially lagging behind the needs of the economy. And since 1991 lagging even more, as economy has accelerated sharply, demanding in consequence more infrastructural facilities. But the antiquated infrastructure is a problem largely due to the highly restrictive regimes of land ownership and use.¹² The same is with mineral resource exploitation; India has a lot of coal and some other valuable mineral resources, but mining was also nationalized during the Indira Gandhi rule and remains there to this day. So, for example, electricity generation is constrained by both restrictions on land use and on the mineral licensing. Moreover, according to some Indian experts, land use and mineral licensing are areas of large scale corruption.¹³

With respect to lagging infrastructure and land regulations it might also be worthwhile to note again the accusations of post-1991 governmental strategy of giving priority to the service sector at the expense of manufacturing. This was already disposed of, but Douhan and Norberg linked the alleged priority with

¹¹ Edward Luce, *In Spite of the Gods* (London: Abacus, 2007), 199–200.

¹² See D. Kapur, T. V. Somanathan, and A. Subramanian, "India: Land-Shackled, Part 1 and 2," *Business Standard*, July 2014.

¹³ See Aiyar, *Escape from the Benevolent Zookeeper*.

yet another fault of that strategy, namely the resultant neglect of the technical infrastructure, which is more heavily used by manufacturing, requiring the transportation of goods, by road or rail, than by services.¹⁴ But the argument borders on the ridiculous. The infrastructure is required to carry manufactured goods regardless of whether they are locally produced or imported! If domestic producers need less transportation because they are weak competitors for foreign producers, demand for transportation infrastructure will be the same due to the demand of wholesalers and the trade sector in general. Thus, infrastructure is lagging because of other problems (among them those signaled above).

Finally, with respect to the range of second generation reforms one cannot forget about two very difficult areas, reaching beyond the deregulation of production factors. They are, first, the safety net: social, or welfare, assistance and, second, public administration, both intertwined with the corruption issue. To begin with the first, India's social assistance system is based on distribution of physical goods. As such, it is inefficient and moreover corruption prone. The already quoted Edward Luce notes with respect to food that up to half of India's subsidized food for the poor is stolen; up to 40% of below-poverty-line cards, entitling a person to receive subsidized food, is obtained fraudulently, by bribing a respective bureaucrat; and the food available at the so-called Fair Price shops is of a very substandard quality.¹⁵ Free allocation of water, of electricity, etc., is also an object of abuse.

To give another example, the major endeavor of the Congress party-led government in the past decade, the Rural Employment Guarantee Act, offers a hundred days of manual labor to everyone living in the village at a minimum wage (depending on the state, between \$1 and \$2 a day). So a kind of *state serfdom* is offered, which through wrong incentives keeps villagers in their servile, unprofitable activity. Freeing the opportunity to work in labor-intensive manufacturing, in construction, and in private services in the cities would be a much better option, but "bloody do-gooders"—to use an American expression—know better.

What can be done? Classical liberals, such as Deepak Lal, point the way that both offers choice and cuts corruption.¹⁶ Social assistance for three to four hundred million of the poor in the villages and in the cities, their safety net, should be paid in cash. Transfers in kind should be sharply limited. Such measures would reduce to a minimum welfare bureaucracy, cut costs and fraud. With respect to merit goods such as education and health, they could be allocated in the form of vouchers for the same reasons.

The toughest test for the second generation of reforms, however, will be the improvement in the quality of governance. Here India is doing as badly as other BRIC countries (and, with respect to some indicators, even worse). But it means

¹⁴ See Douhan and Norberg, "Is the Elephant Stepping on its Trunk?" 7ff.

¹⁵ Luce, *In Spite of the Gods*, 83–4.

¹⁶ See his opinion column on "Restraining Leviathan," *Business Standard*, 2014.

taking on the bureaucracy, the 20-odd million people, whose salaries in the aggregate amount to more than all social assistance programs for three to four hundred million of India's poor. And many of them add to their not inconsiderable wage income a lot of additional income from corruption. Moreover, the constitution makes them irremovable as far as their public servant status is concerned.

Even if India grows mostly in spite of successive governments, better performing public institutions are also a must. After all, I presented in Part II, Chapter 5, some evidence that high quality of institutions is necessary if a country is to cross the Fatás-Mihov "Great Wall," the divide between middle-developed, middle income and highly developed, high income countries.

India is a country of many contradictions, as I noted in my 2012 article.¹⁷ Its structural change in the process of economic development is atypical. It is the poorest BRIC country, if measured conventionally by GDP per capita, which is trying to reach the level of the middle developed, middle income economy. It is, then, the furthest of the four countries considered here from the "Great Wall." Yet, at the same time, its sectoral GDP and employment structure is more similar to advanced, highly developed economies than to old industrialized and newly industrialized economies.

The fact that the share of manufacturing in India's economy never even approached the historical inflection point of, say, 30% GDP may be seen as a weakness of Indian economy, a measure of failure of Indian industrialization. But at the same time India, as it was stressed already, registers the fast growing, sophisticated, human capital-intensive subsector of market services. It is on the level with the world best in the information technology services and not far behind in some health care services, finance and business services. The share of sophisticated service exports in aggregate exports is in India the highest among the BRIC countries.

Sophisticated services apart, the potential for closing the structural gap with respect to industrialization simultaneously with expanding modern services—characteristic for advanced, high income economies—does exist in India. India is indeed markedly different in its pattern of structural change from the rest of the BRIC group, and from most industrializing Southern economies.

Whence comes the potential in question, which I regard as the highest in terms of the prospect of crossing the "Great Wall" among the four BRIC countries, regardless of India's well-known distortions? The answer is in its vibrant, decentralized democratic political system. As Fareed Zakaria rightly stresses, "democracy makes for populism, pandering, and delays. But it also makes for long-term stability."¹⁸

Within the framework of such a long-term stability and the no less vibrant society a decentralized, private ownership and private initiative-based economy

¹⁷ See Winiecki, "The BRIC Group."

¹⁸ Zakaria, *The Post-American World*, 156.

may flourish. As I stressed in my 2012 article, it is primarily in such an economic, civic, and also political freedom-based environment that the innovations in the area of investment (both tangible and intangible) emerge.¹⁹ Again, Chapter 5 above supplies some empirical evidence for my earlier formulated thesis, along the lines of Fatás–Mihov thinking about the conditions required to cross the “Great Wall.” One thing is certain, namely that the process of approaching and crossing the “Great Wall” will not be linear. But the kind of polity and even more its society increases India’s prospects for success.

It will not be easy, especially with respect to catching up with the expansion of traditional manufacturing. The victor in recent national elections, new Prime Minister Narendra Modi in his first Independence Speech invited the world investors to come and produce in India. Many hope that Modi, a former PM in the best performing Indian state of Gujarat, will continue to modernize a country at large. There is no doubt of the “desirability of India becoming the next China or the next Gujarat” wrote some time ago Amrit Amirapu and Arvind Subramanian,²⁰ but they note that India fell long ago into the pattern of “premature deindustrialization.” Manufacturing share peaked (in fact double-peaked) between 1978 and 1996 with the share of 16–17% GDP—and at a very low GDP per capita level.

To reverse that pattern would require a very large-scale change in the quality of Indian institutions and—even more—policies. The combination of a—long awaited—government with a strong reform mandate, combined with the pro-reform pressure from the vibrant, expanding middle class could accelerate the process. And not only with respect to manufacturing expansion.

Brazil: A Country Where the Future Has Arrived (Well, Not Quite...)

One of the very perceptive observers of the world economy, Guy Sorman, chose the phrase: “The Future Has Arrived in Brazil”²¹ to describe the situation, when the country seen as having a great potential finally turned it into a reality. Unfortunately, regardless of the major positive changes accomplished in the preceding two decades, the reality does not point to the “glittering future.”

Two recent reports on Brazilian economy, one by McKinsey & Co. and another by Boston Consulting Group,²² in spite of using identical phraseology of “immense potential,” reveal serious problems with Brazil’s economy, especially its

¹⁹ Winiecki, “The BRIC Group.” On these general conclusions, see also *ibid.*, “Russia and China Facing the ‘Great Wall’: How To Succeed in Second Structural Transition,” *Post-Communist Economies*, vol. 24 (2011), no. 3, 309–26.

²⁰ See “India Must Reverse Its Deindustrialization,” *Business Standard*, May 2014.

²¹ Guy Sorman, *L’économie ne ment pas* (Paris: ArthèmeFayard, 2008). The quote is from the Polish edition (2009), 151.

²² Respectively, McKinsey Global Institute, “How Brazil Can Grow,” December 2006; and BCG, in cooperation with BRAiN, “Charting a Steady Course,” April 2013.

institutions and policies pursued within these institutions. And the business press fills the pages with criticism of both policies and numerous examples of existing problems. Without tackling at least those problems, which most adversely affect economic performance, Brazil prospects do not look as promising as their elites might have imagined.

But let us start with what is right with Brazilian economy, or, more precisely, what changed for the better over the past two decades. Worth emphasizing is what Guy Sorman stressed, that is, the emergence of normal macroeconomics—something that only very slowly has been taking roots in Latin America. After repeated bouts of high and even hyperinflations, as well as changes in currency units, a finance minister and later two term president, Fernando Henrique Cardoso, suppressed hyperinflation, established an independent central bank, and made public expenditures not so much smaller, but at least more balanced and more transparent. In Latin America, where leftist ideologies have been cherished and added various exotic economic recipes to their armory (*dependentia*, "structuralism" applied to macroeconomic policy, etc.) it was no mean feat.

Brazil's politics also stabilized. Cardoso, a radical neo-Marxist in his youth, turned economic liberal, was superseded by another extreme leftist, this time trade unionist-practitioner, Inacio "Lula" da Silva who—after being elected president—turned social democrat and did not destroy the recently achieved macrostability (as it often happens with revolutionaries in Latin America). Thus, the dominant political spectrum ranges nowadays in Brazil from conservative/liberal to social-democratic, not much different from Europe or the United States. "Lula" also added a moderate welfare state expansion to offer the poor some basic health, education and other services. Some solutions are atypical, for instance, financial assistance to the poor under the condition that they are going to send children to school, but they turned out to be successful. The income of the poorest 10% of the population grew in the first decade of the twenty-first century by 7% *per annum*.²³ In consequence, the Gini index of inequality, although still exorbitantly high (approx. 0.50), has declined.

The government even began to start tackling one of the oldest ills, particularly persistent and large-scale in Latin America, that of the oversized grey economy. Its share in Brazil amounted to half of all the employment at the turn of the century, but has declined to (still very high) of 40.0–35.0%. Some tax incentives have been used to draw the informal firms to the formal economy, by reducing tax burden for small firms. Too little, but at least a small step has been made in the right direction.

All the foregoing positive changes, large and small, should have resulted in more stable and faster economic growth. And more stable it was, but faster it was not. At least, not much faster. To understand why, one should note the peculiar Brazilian elite's thinking about Brazil as a potential great power. And, next, to

²³ See BCG, "Charting the Steady Course," 7.

look to a specific pattern of long-term commodity price changes that I stressed in some earlier publications.²⁴

Brazil's "great potential," hovering above that country for decades (or even longer), makes these elites prone to dreaming about the great power status. Sometimes, rather rarely, the dream pushes them to pursue some sensible economic reforms to accelerate economic growth as an undoubtedly proper way to get closer to the realization of the dream. This is what happened twice over the last half a century.

In the mid-1960s the government of the day decided to liberalize the economy in some respects. They liberalized foreign trade and reduced some, more burdensome, regulations at home. The result was a spurt in both economic growth and manufactured exports. Brazil was performing at that time at the level of four "little dragons" of East Asia (see Table 3.2 in Part I above).

However, the previous long-term commodity cycle changed relative prices, benefiting their producers. In the early phase of the price growing period (1972–77), Brazil and other commodity producers benefited a lot (in the late phase, 1978–81, only crude oil producers gained). Nonetheless, seeing ahead a road to greatness based on the pure commodity price increases, the ruling elite abandoned reforms—liberalizations always makes some influential groups unhappy—and decided to chase the great power status on the basis of high commodity prices (presumably lasting forever!), tighter bureaucratic control over the private sector, and further, state-driven, expansion of heavy, capital-intensive industries. The chase ended almost twenty years later in the flames of hyperinflation and sharp decline in economic growth (it barely exceeded 2% annually in the 1980s and early 1990s).

The reforms under the finance minister and later president Cardoso injected another dose of liberalization into the economy, combined with the establishment of a healthy macroeconomic framework. However, the next, ongoing, long-term commodity cycle interfered again, reviving the same great power temptations.

With commodity prices rising since mid-2000s and Brazil looking additionally blessed with newly discovered large off-shore oil deposits, the current elite started chasing again the great power dream without reforms. Instead of second generation reforms that would improve the performance of Brazilian economy as a middle-developed, middle income one on the way to an even higher status of the advanced, high income economy, another generation of dream chasers decided to take the same route to greatness: impressive state investment pro-

²⁴ Jan Winiecki, "Zmiany w gospodarce światowej z perspektywy cyklu surowcowego" [Changes in the World Economy from the Perspective of a Long-term Mineral Resources' Cycle], in *Kryzys światowy. Początek czy koniec?* [A Global Crisis: The End or the Beginning?], ed. Jan Winiecki (Gdańsk: Regan Press, 2009), 85–109; and *ibid.*, *Economic Futures of the West*, Chapter 2.

grams in many areas of the economy, state-driven faster growth and (this time) also faster redistribution.

However, the price rising part of the cycle—usually lasting 8–10 years—has recently ended. Moreover, large scale investment expenditures either bring about meager economic returns or their completion is much delayed (signaling, by the way, much higher costs and meager returns also in the future!). The restrictive rules concerning off-shore oil not only slowed down exploration and extraction, but also deterred foreign capital from both participating and simultaneously technologically strengthening all phases of the process.

And, again, since 2011 economic growth slowed down to, roughly, between 1% and 2% annually. The great power dream looks like being postponed, again. All the more so, because if one evaluates Brazil's economy at a less aggregate level, the problems it faces and the range and depth of reforms required look daunting.

Various studies point to a smaller or larger list of urgent problems to be tackled. There is, however, one overarching problem, namely *the government that is much too big (in tax terms) and very much too intrusive (in regulatory terms)* for the economy to be able to grow spontaneously and display usual productivity dynamics, characteristic for such growth.

Let us start with taxation and public expenditures. Thanks to the discipline imposed by president Cardoso and—by and large—maintained by his two successors, there is not much difference between revenues and expenditures. Budget deficits have been manageable in the past two decades. However, the state in tax terms is too big for Brazil's level of economic development.

With US \$8,400 per capita GDP in 2004 on PPP basis and now approximately US \$10,500, the Brazilian state imposes a total tax burden on the economy as high as 36% GDP. It is way too high if compared with the OECD countries, when they were at the similar level of economic development that Brazil is now (US \$11–12,000). Thus, Japan and South Korea registered in 1970 and 1993 about 21–22% share of public expenditures in GDP, while Spain and Greece in 1973 respectively 23.6% and 25.8%. Even the archetypal welfare states like Norway in 1963, Finland in 1969, and Sweden in 1961 registered a lower total tax burden of 32.0%, 32.5%, and 33.4%!²⁵

Brazilians' tax burden is, in reality, much higher if measured in terms of those who do pay taxes. After all, at the turn of the century about half of Brazil's labor force was employed in the grey economy and even now it is more than a third, which means that taxes have been imposed on a part of the economy. Unsurprisingly, payroll tax is in Brazil 58% (2/3 of it paid by employers), much higher than in OECD countries.

²⁵ Andrzej Rzonca, "Mity w dyskusjach o gospodarce" [Myths in Economic Discussions], Paper presented at the Blikle seminar, Warsaw, 2007, mimeo.

As a consequence, a part of Brazil's problems with a state too big for its level of development, stems from the existence of a very large grey economy. Creating incentives to reduce the grey, informal sector is a very important task. Let me repeat: creating incentives to shift from informal to formal economy, not fighting the "informals." There may be more losses than gains from the advice to "tackle" the informality by squeezing the "informals" as the McKinsey report on Brazil of December 2006 seems to suggest.

One should never forget that the main source of the existence of a large grey economy is the costly regulatory and bureaucratic intrusion into minute details of any economic activity. After all, Brazil is together with the now defunct Soviet Union the co-inventor of a specific occupation, namely that of the "fix-ers" (called *dispachantes* and *tolkachi* in the respective languages). They were called upon to arrange things that in a normally functioning market economy are solved almost effortlessly.

But not in Brazil: in 1970s and later a firm needed to obtain the approval of the authorities to move a computer within the firm from one floor to another! That in Latin America, including Brazil, the problem is with the regulations and the bureaucracy was already well documented in the now famous Peruvian experiment of establishing a medium-sized clothing firm in Lima that took more than 250 days, required filling forms that together, page to page, were about 90 yards' long and on top of it required eight bribes.²⁶

People by and large enter and remain in the grey economy because they cannot afford to enter the regular one. Tackling informality should not entail, for example, the withdrawal of existing lower tax rates for small firms. These lower taxes were successful in weaning away from the grey economy a number of such firms and should be extended to the whole business sector by reducing the corporate and payroll income taxes across the board. Obviously, that entails revenue losses, but it should be remedied not by increasing the tax burden elsewhere, but in reducing state expenditures. They are, as shown above, much higher than an economy at Brazil's level of development can afford if it wants to grow faster than it does today and grow also through the increase in the level of productivity (another weak spot of Brazil).

Brazil, like India, spends too much on its bureaucracy and the public sector in general. The welfare state may be rudimentary and insufficient for the population at large, but it is well developed and exceedingly generous in terms of salaries and pensions for the servants of the state. Even outside the public bureaucracy, an average teacher, usually a female, starts working at the age of 25 and retires at 50 at full pension, which means—at the present level of life expectancy—that she (or he) is going to receive it for more years than the number of

²⁶ See Hernando de Soto, *The Other Path: The Invisible Revolution in the Third World* (New York: Harper and Row, 1989).

years she, or he, worked.²⁷ In more general terms in spite of very high contributions to the pension system for the public sector, as well as for the private sector, both are in deficit and need additional financing from the budget. Worse still, the (slowly) growing revenues from the oil extraction on the continental shelf are being spent on pensions rather than on development! Clearly this is the area that, together with other public sector distortions, needs to be "tackled."

It is always difficult to reduce the exorbitant privileges of the bureaucracy and that of the public sector in general. However, to stay with the pensions only, Brazil is spending on pensions a greater share of GDP than Germany with barely a third of German old-age dependency ratio!²⁸ Without the reduction of these and other privileges the cuts in public expenditures to balance reduced revenues from tax cuts would be extremely difficult.

Another area of savings is also associated with bureaucratic procrastination, namely infrastructural investment. It is true that Brazil notoriously spends much less on technical infrastructure of the economy than other emerging economies. But whatever little is spent, is usually years behind schedule and costs much more than planned.

The foregoing applies, by the way, not only to infrastructure, but also to state firms and state supported private firms, beneficiaries of the subsidized credits from the Brazilian Development Bank (BNDES). Most recently, Petrobras has been under fire for its investment excesses. But apart from that the state oil giant has been used by last two governments to keep oil prices below equilibrium level, with highly adverse effects on firm's profitability, of course.²⁹ So, again, the state Leviathan needs to be tamed and reduced to a markedly smaller size. Only within such a tax regime/regulatory regime framework, combined with curtailing the privileges showered on beneficiaries of the Leviathan, the more specific changes should be considered.

Thus, there are far from completed tasks of liberalization of the enterprise sector. Since the beginning of this century more and more of medium-sized private firms performed well on domestic and at times on international markets, some of them even becoming listed in the stock market. There are some industries, where private sector firms outperform public sector firms by 2:1 in terms of productivity (large-scale retail trade, banking).

However, Brazil is another country—like India—that has been suffering from premature deindustrialization. Its share of manufacturing in GDP fluctuated between 21.0% and 19.4% GDP over the 1980 and 2008 period.³⁰ Other statistics show much higher share in GDP at the beginning of the period. Thus all the successes of private firms have been taking place in the period of shrinking share of the manufacturing sector, taking place at much lower level of GDP

²⁷ See the special report on "Brazil: Grounded," *The Economist*, September 28, 2013.

²⁸ *Ibid.*

²⁹ "The Creaking Champions," *Financial Times*, April 22, 2013.

³⁰ After Naude et al., "Industrialization Lessons," 11ff.

per capita than it used to be the case with respect to West European and other Western economies.

An interesting area of progress is large-scale private agriculture. Left alone (no subsidies, but also less regulation than in the past) it thrived in the past 10–15 years, making Brazil's agricultural exports highly competitive on the world markets. The problems begin, when very efficient private producers have to ship their products hundreds of kilometers by overloaded and unrepaired roads to the no less overloaded ports. Extra difficulties emerge, when they face there the trade unions and their go-slow/pay fast attitudes.

Here, the issue of private sector superiority in terms of performance faces the problems of underdeveloped (and overloaded) infrastructure. Each and every major infrastructural investment program has proven the across the board inferiority of bureaucratic planning and execution with respect to infrastructural projects. And yet the acceptance of private investment in infrastructure had been rejected for decades. Even the public/private partnership in that area has been viewed with suspicion. Grudgingly accepted nowadays, it is rarely implemented; many projects simply remain at the program stage rather than being competitively auctioned to private sector highest bidders.³¹

Thus, the question of a state that is too big tax-wise and too intrusive regulation-wise pops up at nearly every problem area. The underdeveloped manufacturing sector that if left alone would probably expand faster and in a more competitive manner would have probably been the greatest beneficiary of such institutional (not only policy) change.

Its relative underdevelopment, also with respect to its share in aggregate employment, is undoubtedly the downward distortion resulting from multiple—and mostly harmful—state interventions over the whole post-World War II period. Most productivity problems of Brazil manufacturing and the economy as a whole would, probably, disappear as well under the more spontaneous development, reacting to market incentives. The foregoing comment applies also to the technical infrastructure if private sector is allowed there to compete on equal terms.

A partly different set of problems concerns the distortions in social infrastructure. In the latter, problems are more of quality than quantity. As in many poorer countries with strong political/bureaucratic elites, Brazil developed a moderate quality higher education (largely for the elite itself), but rather low quality primary and secondary education. With respect to the latter, in comparisons made in the BCG–BRAiN report Brazil is lagging behind, for example, China and Russia, as well as behind Chile and Mexico. In the report by *The Economist*,³² the authors stress that Brazil spends 5.6% GDP on education, more than the OECD average, but the proportions are skewed. Rich countries spend 30% more on each student than on each pupil; in Brazil a ratio is 5:1.

³¹ For more comments and examples, see “Brazil: Grounded.”

³² Ibid.

At the same time performance in both primary and secondary education is, as stressed already, inferior: in PISA tests Brazilian pupils fall also behind Turks and Argentines, remaining at the bottom of the countries taking part in the tests. As usual in Brazil, the answer of the ruling elite is a big spending program, which—if implemented—would increase the share of education in GDP to 10%, a world record. Given the already exorbitantly high public expenditures for Brazil's level of economic development, the program is unrealizable, with extra oil revenues or (even more) without them. So, again, the productivity issue comes to the fore also in social infrastructure. The state should be smaller and more flexible. But both are an anathema for the well paid, entrenched bureaucracy. And for those politicians believing in their dream of the great power status for whom the best solution is to use the money of the almighty state.

So, is there a solution? In spite of all the criticism in the foregoing comments on Brazil, it is still a relatively rich BRIC country, close to Russia and (barely) ahead of China and ahead of India. It spends a lot, even if badly, on education. It is a democracy, which—as in the case of India—means that it is politically more stable in the long run (no Mao Zedong-style "Great Leaps Forward," in spite of great power status dream!). In Brazil, as in India, a great hope is the large increase in the middle class, the mainstay of moderation, barrier against waste (see recent demonstrations in Brazil against the wastefulness of big spending on major sporting arenas), and the major source of pressure for serious reforms.

POSTSCRIPT:

On Choosing Inefficient Institutions

Part I of the book, dealing with developmental strategies pursued over the last hundred years, proved that the majority of countries on our planet tended to choose bad, that is inefficient, collectivist economic institutions. And even more often they choose bad policies within their chosen institutional frameworks.

Many countries got stuck with these inefficient institutions for decades (or forever), many more made some (usually minor) institutional improvements and policy changes, while a—relatively small—minority of countries pursued more or less by trial and error their search for good, that is efficient, economic institutions. Chronologically the first among the success stories were four East Asian “little dragons” (preceded by Japan), while the latest wave was that of the eight post-communist countries, historically being a part of the Western civilization (their stories are told in Part I, Chapter 3).

Even highly developed Western countries that over a number of centuries had already built good institutions—Western Europe and its offshoots (United States, Canada, Australia, and New Zealand)—fell into the trap of introducing some inefficient, collectivist institutional arrangements and applied bad policies more frequently than before.

The foregoing generalizations are not surprising in historical perspective. In the first part of my book I dealt with the last century only, but the judgment of economic historians extends the generalizations concerning bad institutional choices—and the resultant economic stagnation or near-stagnation—to the whole history of organized societies (roughly over the last 10 000 years). Answers to the question why this has been the case have concentrated on the structure of incentives. The assumption has rightly been made that it is in the interest of the ruler or a ruling elite to establish institutions (rules of the game) that benefit first of all those who rule, as well as those who are the pillars of their rule. And these choices have been made in full consciousness of the fact that other institutions than those of the predatory state could create more wealth.

Yet another point should be made here, namely the existence of two different developmental challenges. The first, creating a more efficient economy with industry, primarily manufacturing, as the main driver of economic growth. Strategies considered in Part I address the problem in question. However, after accomplishing basic industrialization goals, the country, with a much higher development level, conventionally measured by GDP per capita, is going to face the next developmental challenge. It is a shift from a manufacturing-driven industrialized economy to a market services, or more precisely: human capital-intensive, market services-driven highly developed capitalist market economy.

These two particular transformations in the process of economic development are dealt with in Part II. Chapter 4 describes in some detail the emergence and general patterns of the manufacturing-driven industrialized (or only semi-industrialized) economies, as well as offers some corrections and points out limitations of the established theorizing. Probably the most important is the issue of the quality of institutions raised by Francis Fukuyama. He stressed the economic growth successes of some countries noted for the limited extent of economic freedom accorded to their economies (to say nothing about weak or non-existent *civic* political freedoms) and drew the conclusion that to achieve such high growth performance it is enough to introduce “good enough” institutions. Fukuyama’s view is in accord with that of Douglass C. North et al., who also stress that basic industrialization is achievable within what they call “the limited access order” system, where such freedoms are more or less strongly circumscribed.

My reservations to both opinions (I might have added for good measure also Daron Acemoglu and James Robinson’s views, who display a somewhat similar type of approach to developmental issues in their 2006 and 2012 books) are based on two different types of arguments. The first concerns the particular phase of the economic development process, where Fukuyama and others’ view on the limited importance of economic and other freedoms may apply, while the second relates to these countries’ prospects for success within the framework of the long-term historical process of economic growth.

Thus, I offer convincing argumentation that tolerable (“good enough”) economic institutions may be sufficient to achieve basic industrialization goals, but are definitely deficient in accomplishing the next major phase of structural transformation. Chapter 5 in Part II sheds some light on the ongoing structural transformation, aimed at changing the level of development from the industrialized, middle-developed, middle income economy to the highly developed, high income economy (North et al. call it the transition from “limited access order” to “open access order” regime, while Acemoglu and Robinson, in a typical Marxist manner, write about overthrowing the elites as the dominant—if not actually the exclusive—way of systemic change). However, the success of such a change depends, in my opinion, to a very large extent on the existence of good quality, not good enough, institutions, understood as those which offer a high degree of economic, civic, and also political freedoms.

The second line of argument points to the historical process of economic growth that has been markedly accelerated by the emergence of the fossil fuels as a basic source of energy in the world economy, the so-called “Promethean growth.”¹ The nineteenth and twentieth century “Promethean” economic growth and (usually modest) successes in improving the standards of living in many poor countries trying to achieve the goals of industrialization have been—in my opinion—possible mostly (if not only) due to the existence of these “Promethean” opportunities. Especially typical collectivist regimes, like the late unlamented Soviet and other communist ones, would not have registered positive—and in some periods even high—economic growth if it had not been for the plentiful availability of fossil fuels. Given their highly distorted structure of incentives, they would not have been able to grow *at all* under the classical Smithian rules of the market that dominated in the eighteenth century economy, characterized by the scarcity of energy.

However, even the plentiful availability of energy would not much help countries approaching the middle-developed, middle income level of development, trying to advance to the level of a highly developed, high income economy. Considerations in Chapter 5 point to causes of the foregoing view. The growing role of investment in a vast array of intangible capital—alongside that in traditional, tangible capital—suggests the absolute necessity of what some call high quality institutions (not exclusively economic).

Intangible capital requires not only freedom of research: of choosing the subject, pursuing particular methodology, and presenting—without fear of reprisals—the results. Intangible capital is created through the wide variety of activities. It may start with some mundane issues like establishing the data bases. But it also covers a variety of innovative property arrangements: from rights to discovered mineral riches, through the costs of copyrights and licenses, to financial innovations, to rights in architectural and engineering design. Finally, intangible capital is created within firms, whose organizational capital is continuously applied to various technological innovations, typical for tangible capital.

I stress these details in the postscript to underline the necessity of looking beyond the traditional demand for high quality of economic institutions (understood as a high level of economic freedom). Analysts should accept the necessity of civic and political freedoms as a part and parcel of high quality institutions required to advance to the level of highly developed, high income economies. And this is, in fact, what one finds in, for example, North et al.’s recent publications, where such shift is defined as the change from the limited access to open access order.

In Part III, in the light of the foregoing, I consider the prospects BRIC countries face to cross the “Great Wall”: the barrier between middle-developed, middle-income and highly developed, high-income economies, in accordance

¹ Pointed out by Lal, *Unintended Consequences*.

with the definition of Antonio Fatás and Ilan Mihov. All four countries considered in Chapters 6 and 7 (Russia, China, India, and Brazil), candidates for such an advancement to the world of highly developed, high-income economies, will face a large number of specific problems to overcome. More importantly, however, they will face an overwhelming challenge to sharply improve the quality of (economic, civic, and political) institutions. Such approach to their prospects suggests which countries may encounter stronger barriers on the path to prosperity.

I could have completed this Postscript at this point if it had not been for the existence of some intellectual loose ends as far as developmental patterns are concerned. They pertain to both new, increasingly popular ideas, as well as some perennial, but usually neglected or misrepresented issues.

To begin with the former, it is worth stressing that recent theoretical developments add much value by stressing the importance of the politics–economics interaction in economic development and the major role played by containing the threat of violence within ruling elites through the spoils’ system, that is, the creation and distribution of economic rents as payoffs for maintaining peace—in the interest of the elites, but at a cost to societies. This is the nature of “limited access orders” of North et al., and any shift from such, predatory to good, that is, efficient, institutions, is predicated on the highly uncertain transition to “open access orders.” The road to the latter institutions remains unclear in that literature and some suggestions offered seem often doubtful in my opinion.

There is, moreover, a parallel danger of giving too much weight to the political/military role in the politics–economics interaction in the process of economic development. The history of the West points to the primacy of economics in initiating economic change in the long run,² as well as in the particular ways in which such change had often been accomplished.

Thus, even if North et al. declared most recently that “viewed in the context of long-run history, the developed world is decidedly abnormal,”³ while stagnant, less developed economies were more or less a norm, such conclusion should not deter us in our efforts to learn from their history. Especially valuable is—in my view—the oft repeated experience of expansion of economic and at times also political freedoms through cooptation, that is extension of these freedoms to other groups and social strata, which gained over time in *economic* importance.

Economic change was accomplished much less often through major jumps, shifting rapidly a given economy from predatory, inefficient economic system to the representative, efficient economic system. These jumps resulted, according to the now fashionable views of North *et al.* and, even more, from those of Acemoglu and Robinson, from violent overthrow of a given ruling elite.

² This had been admitted long ago by the same Douglass C. North and Robert Paul Thomas, *The Rise of the Western World: A New Economic History* (New York: Cambridge University Press, 1973).

³ North et al., *Politics, Economics, and Problems of Development*.

More often than not, Western history was played differently, though. For example, such a classical institution like *Magna Carta* of 1215 was a very exclusive, very limited access set of rights acquired by the most powerful lords of the realm in Norman England. Over the centuries, however, these rights were extended from one social stratum to another as other strata gained in economic and, with a lag, also in political importance. In another case of Holland, although the eighty years' struggle for independence from Spain was marked by intermittent military conflicts, the emerging decentralized economic order, based on well-defined property rights, was an outcome of the long process of evolution within and among self-governing Dutch cities.

How much of that historical experience may guide the countries that have been trying first to industrialize and then advance to the league of highly developed, high income economies in the recent decades and/or will try to do so in the not too distant future? I described in Part I, Chapter 3, the story of East Asian "little dragons" and especially that of South Korea. Although the political development of that country has been interspersed with *coup d'états*, economic development of South Korea has only been loosely associated with such discrete changes. Typical, Western style, trial-and-error has been the dominant pattern of intermittent progression and occasional regression. This has been even more the case of Taiwan (but not necessarily of Singapore, for example). Post-independence India also fits largely into the pattern of evolutionary changes (for the worse after 1947 or for the better after 1991), but with much less frequent major economic modifications and—fortunately for India—almost no political upheavals, except for the turbulent period of Indira Gandhi rule. These are not the only cases of evolutionary instead of drastic, often violent, change. However rare, Western historical experience and even rarer non-Western experience of that sort should not be so easily dismissed.

The next intellectual loose end concerns the nature of good and bad economic systems. Throughout the post-World War II period we learned to look at these through the lenses of the dominant conflict of the period, that is the East–West conflict. Thus, we looked at economic systems using the terminology of individualist, market-based, and collectivist, state planning and administration-based systems. However, even then the majority of the countries of the world, that is, less-developed countries of the South, did not comfortably fit into any of these categories.

Nonetheless, I am inclined to stick to the individualist vs. statist-collectivist economic systems, even if the latter displayed a much greater variety of ownership patterns and institutional *cum* policy arrangements. Also, the recent ideas of North et al. tend to support such choice of terminology. After all, what emerged from their deliberations on the limited access order was that the predatory regimes have mostly operated as *collectivities*, that is, coalitions of powerful leaders maintaining peace and ruling through the creation and distribution of economic rents among themselves. Only (the highly uncertain) process of suc-

cessful shift to an open access order changes the pattern decisively in favor of the competition-based individualist order. Thus, the dichotomous collectivist/individualist terminology continues to retain its validity.

Finally, coming to a close of the Postscript, I would like to refer to one more intellectual loose end—this time of long standing—that I briefly addressed in my most recent book *Economic Futures of the West*,⁴ namely, why people choose inefficient institutions? The standard answers to the question have concentrated on the structure of incentives. In fact, this is what I have done myself, mostly throughout Part I in this book. But this is not—in my opinion—the whole answer to the question posed above.

The problem is that although concentration on the structure of incentives has impeccable credentials in economic theory, there is also ample—if not actually overwhelming—evidence that quite often ruling politicians made choices that were actually injurious to their own important interests. More than that! The choices they made of these (bad) institutions were widely supported by intellectual elites, religious hierarchies and their teachings, as well as, at times, by the masses themselves...

The perception of the foregoing oft-repeated pattern led me to conclude that—apart from interests—it is *ideas* that play a major role in the choice of institutions. Ideas, in turn, are shaped by human imagination concerning the way the world works. However, the ideas how the world works *in reality* are inextricably linked with other ideas on how the world *should* work. It is from the clash of these two types of ideas—positive and normative—that the choices of bad ideas are often born.

These bad ideas, giving rise to bad institutions, are very often chosen in preference to good institutions because the former look more attractive due to their *appealing moral foundations*. Institutions built on such (misleadingly) appealing moral foundations turn out to be invariably inefficient. Common, or collective, ownership is one such morally appealing foundation upon which economic institutions have historically been often built.

Karl Popper called such choices the “pressure of history.” Over the very large part of human (and earlier hominid) history, people lived in small hunting-gathering bands. The collective arrangement of that kind was their perceived insurance against the extremely high uncertainty of survival in the highly inhospitable environment. And even if these bands shifted over time to settled agriculture, firstly to group ownership-based and later to private ownership-based regime, the subconscious, half-formed preferences from the distant past survived somehow. Many people, if not the outright majority, are *instinctively* inclined to believe that collective institutional arrangements are good, while individualist ones are bad.

⁴ Winiecki, *Economic Futures of the West*, Chapter 7.

However, the experience of the last couple of centuries proved without doubt that institutions built on collectivist ownership are inefficient and, wherever applied, result in economic failure—and at times in the outright disaster. That applies both to large-scale experiments like the late unlamented Soviet Union, and to small groups, motivated either by religion or socialist ideology. The collapse of the communist political-economic system is a well-known fact. A few hundred of failed small-scale collectivist experiments on American soil from the seventeenth to the nineteenth century are less known, but no less convincing, as shown by Joshua Muravchik.⁵

And yet such collectivist institutions are continuously being proposed, as for example in the most recent book by two intrepid believers in institutional and policy tinkering, Amartya Sen and Jacques Dreze.⁶ The India of their liking is post-independence India, the period that according to another pair of authors, Jagdish Bhagwati and Arvind Panagariya, made their country a “basket case.” Only post-1991 reform turned it into an engine of growth—they stress.⁷

There is plentiful evidence of similar ideological choices based on allegedly higher moral foundations. In the symbolically Orwellian year of 1984, the council of Christian churches in Australia recommended for Australia to adopt the socialist system! Clearly, the reverends did not see the *mane-theke*-fares sign on the—visibly breaking down—Soviet socialism.

They noticed even less the first signs of the decay, moral and then economic, of the collectivist arrangements of the Western welfare states. The welfare state, a subsystem of institutions within the larger political-economic individualist system of liberal democracy and market capitalism, has created a particular network of institutions and policies. Modest in its original aims, the welfare state expanded beyond any reasonable limits—in blissful ignorance of its moral, psychological and, in turn, economic consequences. Ignorance is costly and, in consequence, the welfare state begins to decay before our eyes. This has been a long process,⁸ but the effects of decay, the forthcoming stagnation, is turning it into an increasingly visible reality.

The detour I made by looking beyond West European experience has been made on purpose. I have no doubts that collectivist solutions in the broad sense formulated above will be proposed—and attempted—in European countries and beyond. In a more vague manner a decisively collectivist world order was suggested not so long ago by the previous Pope, Benedict XVI. And unreflective fulminations of the present Pope, Francis, against inequalities, augur as badly for the economic sense of preferences of the Catholic Church. Both signaled where the

⁵ See Joshua Muravchik, *Heaven on Earth: The Rise and Fall of Socialism* (San Francisco: Encounter Books, 2002).

⁶ Sen and Dreze, *An Uncertain Glory*.

⁷ Bhagwati and Panagariya, *Why Growth Matters*.

⁸ See Winiecki, *Economic Futures of the West*, Chapters 6 and 9.

Catholic Church stands in the debate on the choice between individualist *vs.* collectivist institutional arrangements.

As signaled above, these collectivist arrangements have often been and will continue to be greeted with applause by many intellectuals, as well as many societies, seduced by the misleading attractiveness of moral foundations of such arrangements. The fact that similar institutions have already been tried—and found inefficient or downright destructive—does not seem to deter a new wave of believers. It is a typical case of hubris displayed by those who believe that they, the best and the brightest, or the most hard working and pious, will succeed, where so many other failed before. The perceptive realism of Adam Smith who stressed that it is not from the benevolence of the baker that we obtain our daily bread, will not appeal to fervent believers in superior moral foundations of such collectivist arrangements...

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